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TAXATION OF FINANCIAL SERVICES INDUSTRY

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BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

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TAXATION OF FINANCIAL SERVICES INDUSTRY

FRIDAY, MARCH 11, 1983

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 10:04 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Robert J. Dole (chairman) presiding.

Present: Senators Dole, Chafee, Long, Bradley, and Pryor.

Also present: Senator Metzenbaum.

[The press release announcing the hearing, the Joint Committee on Taxation staff report, and Chairman Dole's prepared statement follow:]

Press Release No. 83-114

PRESS RELEASE

FOR IMMEDIATE RELEASE
February 22, 1983

UNITED STATES SENATE
COMMITTEE ON FINANCE
SD-221 Dirksen Senate Office Building

SENATE COMMITTEE ON FINANCE SCHEDULES HEARING ON TAXATION OF BANKS, SAVINGS AND LOANS, AND CREDIT UNIONS

Senator Bob Dole, chairman of the Senate Committee on Finance, today announced that the committee will hold a hearing on Friday, March 11, 1983, to examine the special tax preferences enjoyed by banks, credit unions, savings and loan associations, and other members of the financial services industry.

The hearing will begin at 10:00 a.m. in Room SD-215 of the Dirksen Senate Office Building.

In announcing the hearing, Senator Dole stated, "Recent studies by both governmental and nongovernmental organizations indicate that many financial institutions enjoy unusually low effective tax rates. According to a recent study performed by the Joint Committee on Taxation and the General Accounting Office, twenty of the largest commercial banks in the United States enjoyed an effective U.S. tax rate of 2.3 percent on their U.S. income in 1981.

"Many of the special provisions and tax preferences that keep these rates low undoubtedly had some justification when they were first placed in the law. But Congress has a responsibility to reexamine these preferences, and determine whether they can now be justified, in light of the much higher effective tax rates borne by most other business and individuals.

"If the Finance Committee is directed by a Budget Resolution to raise revenues, I believe we must insure that all industries are paying their fair share before we consider proposals that have been advanced to raise tax rates across the board, or to repeal the tax indexing provisions or the third year tax cut of the Economic Recovery Tax Act of 1981."

Senator Dole noted that, during 1982, the Congress had restricted a number of tax preferences used by both nonfinancial and financial industries. He stated, "In the Tax Equity and Fiscal Responsibility Act of 1982, Congress raised substantial revenues without raising individual or business tax rates, simply by enacting several tax reform proposals that were either contained in the President's 1983 budget proposals or developed in the Congressional process. By restricting the completed contract method of accounting used by the construction and aerospace industries Congress raised over $5.6 billion over the three-year period beginning in fiscal year 1983, and by restricting MODCO and other tax preferences used by life insurance companies, we raised over $7 billion over the same three-year period. In addition, by restricting cost recovery deductions for equipment in the out-years, we raised nearly $30 billion in the three-year period beginning in fiscal year 1985. The Administration's corporate minimum tax proposal would have increased the share of corporate taxes paid by the banking industry by over 50 percent, but that proposal was not enacted."

TAXATION OF BANKS AND THRIFT INSTITUTIONS

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

MARCH 11, 1983

Prepared for the Use of the

COMMITTEE ON FINANCE

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

INTRODUCTION

This study has been prepared by the staff of the Joint Committee on Taxation at the request of Chairman Robert Dole in connection with the Senate Committee on Finance's hearing on the taxation of banks, savings and loan associations and credit unions, scheduled for March 11, 1983.

The first part of the study is an overview. The second part presents data on the amount of income tax paid by banks and savings and loan associations in recent years and the effective tax rate of banks in 1981, along with a discussion of the significance of the effective tax rate concept and some of the issues involved in measuring effective tax rates. The third part analyzes a number of areas in the income tax law where the rules for financial institutions differ from those applied to other taxpayers or where general rules are of particular significance for banks, including discussions of present law, the legislative history and the analytical issues involved.

I. OVERVIEW

This study is an initial effort to address the federal income tax treatment of commercial banks, mutual savings banks, savings and loan associations and credit unions. In recent years, these financial institutions have in most cases either paid no U.S. federal income tax or have paid rates of U.S. federal income tax that are a relatively low percentage of income. For some institutions, a low or zero U.S. tax burden resulted from the fact that few or no profits were earned; however, the relatively low tax burdens of financial institutions also result from a variety of provisions in the tax law that treat financial institutions differently from other taxpayers.

Taxes paid by financial institutions and effective tax rates

In 1978, a relatively profitable year for financial institutions, commercial banks and thrift institutions (mutual savings banks and savings and loan associations) paid about $3 billion of U.S. federal income tax (out of total tax liability for U.S. corporations of $64 billion). $1.6 billion was paid by commercial banks, $1.3 billion by savings and loan associations and $0.2 billion by mutual savings banks. By 1980, the tax liability of commercial banks had fallen to $1.4 billion. 1980 was an unprofitable year for many thrift institutions, however, and the tax liabilities of savings and loan associations fell to $188 million and that of mutual savings banks to $23 million.

It is possible to use published data from annual reports to estimate effective tax rates paid by individual commercial banks in 1981, although such estimates are based on controversial methodological assumptions and can vary widely. In 1981, large banks appear to have paid relatively little U.S. tax, although the tax rate appears to be significantly higher when foreign taxes are counted. To some extent, the low U.S. tax rate results from tax provisions that create a deferral of tax liability that can be expected to lead to tax liability in some future year.

The principal provisions of the law that reduced the tax of banks in 1981 include the exclusion for interest on State and local government bonds and tax benefits associated with leasing activities. To the extent that these investments by banks earned a lower pre-tax rate of return than comparable but fully taxable investments, it may be argued that the banks did bear an indirect economic burden attributable to the income tax apart from the actual tax payments they made.

Specific tax provisions affecting financial institutions

Bad debt reserves.—Commercial banks and thrift institutions are allowed to deduct additions to bad debt reserves in excess of their actual loan losses and, some argue, in excess of what would be needed to produce a proper economic measure of income. In the case of thrift institutions, the excess bad debt reserves are intended to encourage investment in home mortgages and certain other types of assets, but there has been criticism of the structure of this incentive in the light of recent regulatory changes.

Tax-exempt bonds.—Unlike other taxpayers, banks can deduct interest on obligations allocable to tax-exempt securities. Congress placed limits on this deduction in 1982. This interpretation of present law gives banks a tax benefit not enjoyed by other taxpayers, which may create a competitive advantage for banks over other taxpayers, such as broker-dealers, when they engage in similar businesses. Also, there are cases where these interest deductions can lead to what some consider to be too much assistance being provided, such as when bank deposits of a State or local government are collateralized by that government's tax-exempt obligations. However, limits on the deductibility of interest used to purchase or carry tax-exempt securities may affect the market for tax-exempt bonds to the detriment of the issuing governments and other beneficiaries of tax-exempt financing.

Foreign-source income.—Many large banks earn most of their income outside the United States. As a result of the tax rules for foreign source income that are generally applicable to corporations, but perhaps more beneficial to banks because of the nature of their business, banks pay little or no U.S. tax on their foreign operations. Moreover, the rules may be viewed as making certain foreign loans more attractive than U.S. loans. Furthermore, some of the present rules on foreign-source income may operate to permit banks to reduce their U.S. tax burden on U.S. income.

Credit unions.—Credit unions are tax-exempt, even on income accumulated rather than distributed as dividends to their members. Since this exemption was last considered by Congress, some credit unions have expanded to become large, sophisticated organizations, and it may be appropriate to re-examine the exemption.

Dividend deductions.—Mutual savings and loan associations and mutual savings banks may deduct 100 percent of dividends to their shareholder-depositors. In contrast, mutual life insurance companies may deduct only 77½ percent of policyholder dividends. To the extent that dividends of mutual financial institutions are viewed as a return on the equity of the institutions, some limit on deductibility may be appropriate to achieve a proper measurement of income.

Other provisions.—Several other provisions of the tax law provide special treatment for financial institutions, including exemption from the restrictions on commodity tax straddles, the ability to deduct costs of starting a credit card business, special rules for loan foreclosures, special merger rules and special rules for loss carryovers and carrybacks.

II. INCOME TAX PAID BY FINANCIAL INSTITUTIONS AND EFFECTIVE TAX RATES

A. Income Tax Paid by Financial Institutions

The U.S. income tax liability of commercial banks, mutual savings banks and savings and loan associations for the years 1976 to 1980 is shown in Table 1. Total U.S. income tax liability of these taxpayers increased from $1,659 million in 1976 to $3,089 million in 1978, but fell in 1980 to $1,597 million, essentially the pre-1976 level. Income liability of commercial banks increased from $896 million in 1976 to $1,833 million in 1979 and then decreased to $1,386 million in 1980. Tax liability of mutual savings banks rose from $111 million in 1976 to $184 million in 1978 and then declined to $23 million in 1980. Tax liability of savings and loan associations decreased from a high of $1,260 million in 1978 to $188 million in 1980. The sharp decline in tax liability of savings banks and savings and loan associations in 1980 reflected the extremely low profitability of many of those institutions in that year. The data in table 1 do not take into account the effects of net operating loss or credit carrybacks from subsequent years that reduced (or will reduce) tax liability for the years shown in the table. To this extent, they overstate the taxes that will ultimately be paid for these years.

Credit unions paid no income tax because of their statutory exemption.

Table 1.—Income Tax Liability of Financial Institutions, 1976–1980

[In millions of dollars]

Year	Savings and loan associations	Mutual savings banks	Commercial banks	Total
1976	652	111	896	1,659
1977	968	146	1,112	2,226
1978	1,260	184	1,645	3,089
1979	932	124	1,833	2,889
1980	188	23	1,386	1,597

Source: Internal Revenue Service, "Statistics of Income: Corporation Income Tax Returns," various years.

B. Effective Tax Rates of Large Commercial Banks

This section presents an analysis of the effective tax rates paid by 20 large commercial banks in 1981.[1] It includes a discussion of the methodology used to compute effective tax rates from data derived primarily from corporate annual reports. It also includes a discussion of the principal reasons why effective tax rates differed from the 46-percent statutory corporate income tax rate.

Background

One definition of a corporation's "effective tax rate" is simply the income tax it owes in a particular year divided by its income for that year. The Securities and Exchange Commission requires that corporations include in their annual reports a reconciliation between their actual effective tax rate and the maximum statutory corporate tax rate (now 46 percent).[2] Because data from corporate income tax returns are only available several years after the taxable year for which the returns are filed and returns of individual banks are confidential, the annual reports present the most up-to-date and accessible evidence on corporate effective tax rates. However, a number of problems arise in using these data for this purpose. These are discussed below.

If generally accepted accounting principles[3] and tax accounting rules were exactly the same and there were no tax credits, then all corporations would show an effective rate of tax equal to the statutory rate. The differences between the tax and financial accounting rules, and tax credits, account for the difference between effective tax rates and the statutory rate. Some of these differences are referred to as timing differences, which will reverse in a future period, and others are permanent differences, which will not reverse.

Permanent differences arise from statutory provisions under which specified revenues are exempt from taxation, deductions are allowed for tax purposes for items not counted as expenses for book accounting purposes, and specified expenses (for book purposes) are not allowable as deductions in determining taxable income. An example of a permanent difference is the interest received on municipal bonds, which is included in income for book purposes but excluded for tax purposes. Another example is the 15-percent reduction in the amount allowable as a deduction with respect to any financial institution preference item. Other permanent differences arise from items entering into the determination of taxable income which are not components of pretax accounting income in any period. Examples include the deduction for intercorporate dividends received and the excess of percentage depletion over cost depletion. Another type of permanent difference is a tax credit.

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[1] The staff has made no attempt to analyze effective tax rates for other types of financial institutions. Savings and loan associations and mutual savings banks were, in general, sufficiently unprofitable in 1981 that an effective tax rate calculation would not be meaningful.

[2] APB Opinion No. 11 recommends that significant differences between pretax accounting income and taxable income be disclosed. The Securities and Exchange Commission formalized this rule to require a reconciliation of the effective tax rate to the statutory rate (Rule 17, CFR 210.4-08(h)). In addition, any timing difference that is 5 percent or more of total timing differences is generally disclosed separately.

[3] Generally, the rules for accounting for income taxes are described in APB Opinion No. 11, as amended.

In financial statements, an effective tax rate is computed by comparing the provision for income taxes with net income before tax. This effective tax rate is reconciled to the statutory rate by identifying the permanent differences which give rise to the differences in rates.

Timing differences arise from differences between the periods in which transactions affect taxable income and the periods in which they enter into the determination of pretax accounting income. Each timing difference originates in one period and reverses in one or more subsequent periods. For example, depreciation may be reported on an accelerated basis for tax purposes but on a straight-line basis for accounting purposes. Gross profits on installment sales are recognized for accounting purposes in the period of sale, but are reported for tax purposes in the period the installments are collected.

The accounting recognition of the tax effects of timing differences is based on the concept of interperiod tax allocation. Under this concept, the provision for income taxes on the financial statement for a given year includes all the tax effects of the revenue and expense transactions included in the determination of pretax accounting income for that year. Thus, the total tax expense for the year is the statutory rate times income before tax, plus or minus whatever adjustments are needed to allow for permanent differences. Some portion of this expense is due currently under the tax law while the rest will be due in the future. The portion that is due currently is termed "current tax expense," and the portion that will be due in the future is termed "deferred tax expense." [4]

Effective tax rates computed from financial statements

Effective tax rates can be computed from data published in annual reports using various methodologies regarding the appropriate measurement of "taxes paid" and "income." It is important to note that there has been a good deal of controversy about just what methodology is appropriate for this purpose and that the resulting effective tax rate measures can vary markedly.

Deferred taxes.—The principal methodological issue concerns the treatment of deferred taxes. As noted above, these represent taxes which are not currently paid, which would have been paid had the statutory tax rate been applied to book income, and which are not attributable to permanent differences between tax and book rules.

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[4] Deferred tax expense can be negative, which will be the case whenever book accounting principles require that expenses be deducted prior to the time they are deductible for tax purposes or income reported later than the time it is included for tax purposes. Current tax expense can also be negative, which will be the case when carrybacks result in income tax refunds.

Under the book accounting rules, deferred taxes are treated as a current year's tax expense. However, for many corporations, particularly during a period of growth or inflation, deferred taxes roll over from one year to the next and are, in fact, never paid or will be paid in the distant future. The actual burden of each dollar of deferred tax liability, therefore, is less than that of each dollar of current tax liability and will depend upon the period of deferral and prevailing interest rates. Accounting for deferred tax liability as equivalent to current tax liability may be appropriate as a way of obtaining a conservative measure of after-tax income, but it would not be an appropriate way to measure the income tax burden for the purpose of ascertaining a company's or an industry's contribution to Treasury revenues. Conversely, completely neglecting the deferred tax liability will understate the true tax burden to the extent that the present value of the deferred tax liability is positive. (i.e., to the extent that some tax will be paid in the future).

Under some circumstances, a corporation may recognize the future tax benefits of loss or credit carryforwards in the book provision for current taxes. Thus, loss corporations may show a negative current tax expense not only because they are receiving refunds from loss or credit carrybacks but also because they are anticipating use of carryforwards in the future. In this event, the book provision for current taxes may be understated compared with actual tax liability. However, to qualify for current recognition, the future tax benefit of loss carryforwards must be "assured beyond any reasonable doubt".[5] This stringent requirement prohibits the recognition of future tax benefits of net operating loss carryforwards except in unusual and rare circumstances. The accounting rules for claiming a reduction in current tax expense for investment credit carryovers, however, are more lenient.

Effective tax rates disclosed in the financial statements, in effect, are based on the assumption that the present value of deferred taxes is the same as their stated value. In the 1981 Tax Year Corporate Tax Study, done by the staff at the request of Congressmen Pease and Dorgan (henceforth called the Pease-Dorgan Study), effective tax rates were based on the opposite assumption that the present value of deferred taxes is zero.[6] In the study of Effective Corporate Tax Rates in 1981 by *Tax Notes* (henceforth called the Tax Notes Study) deferred taxes were included in the computation of effective tax rates to the extent that the author assumed that they would be paid in subsequent years.[7] Thus, a range of effective tax rates, each based on different assumptions, is available for purposes of evaluation and comparison.

Foreign and nonfederal taxes.—A second important methodological question concerns just what types of taxes should be counted in the numerator of the effective tax rate fraction. (Other taxes should be subtracted before determining the denominator). Should worldwide taxes be counted or just U.S. taxes? Should taxes at all levels of government be counted or just taxes at the Federal level? Should only taxes on net income be counted or other types of taxes as well (like withholding taxes on gross interest income or excise taxes like the crude oil windfall profit tax)? The data on financial statements often do not distinguish between these different types of taxes in order to make possible alternative computations.

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[5] APB Opinion No. 11 (in paragraphs 45–47).

[6] 128 Cong. Rec. H10545, 153–Part II (daily ed. Dec. 20, 1982) (remarks of Rep. Pease).

[7] "Effective Corporate Tax Rates in 1981, A Special Supplement," prepared by the Editors of *Tax Notes*, 561.

Carryforwards and carrybacks.—A third methodological question concerns the effect of carryforwards from prior years into the current year, and carrybacks from the current year to prior years. A net operating loss carried forward from a prior year will reduce taxable income, and consequently taxes, but not necessarily book income, in the current year. Thus, an effective tax rate computed on book income may be understated. Similarly, even in a year when there is book income, there may be a tax net operating loss which can be carried back to prior years. The refunds attributable to this carryback reduce tax liability for book purposes in the current year. Thus, the effective tax rates will be understated and may, in fact, be negative. Income tax credit carryovers and carrybacks can distort effective tax rates in a similar fashion.

The information needed to eliminate the effect on effective tax rates of carryovers and carrybacks is not always available in the financial statements. Consequently, such adjustments are not made in either the Pease-Dorgan or the *Tax Notes* studies.

Effective tax rates of large corporations by industry

The effective tax rates of selected large corporations for 1981, grouped by industry, is shown in Table 2. These come from the Pease-Dorgan Study. Under the methodology used in this study, effective tax rates are computed by comparing reported current income tax expense with net income before tax.

Where data are available to separate foreign and domestic earnings, a foreign tax rate on foreign income and a U.S. tax rate on U.S. income are computed in addition to the worldwide rate on worldwide income. For several reasons, however, the foreign tax rates shown may not be comparable with the U.S. tax rates. The identification of income as either foreign or U.S.-source on financial statements may not be consistent with the sourcing rules for income tax purposes; foreign tax expense may include amounts which are not creditable foreign taxes for purposes of the foreign tax credit; and foreign currency translation gains and losses are treated as foreign income, which can distort the foreign tax rate.

Some effective tax rates in this study are negative. Generally, as discussed earlier, a negative effective tax rate occurs when there is a book income but a tax loss for the year. The tax loss gives rise to a refund (or claim for refund) of past taxes, which is both measurable and currently realizable; therefore, the tax effect of the loss is recognized in the provision for taxes in the current year. Hence, the refund (negative tax expense) is compared with book income (positive), resulting in a negative tax rate.

Table 2.—Federal Corporate Income Tax Rates of Selected Companies by Industry, 1981

[Dollar amounts in thousands]

Industry	U.S. income before tax	Foreign income [1] before tax	Worldwide income [2] before tax	Current U.S. tax expense	Current foreign tax expense [1]	Current worldwide tax expense	U.S. tax rate on U.S. income	Foreign tax rate on foreign income	World-wide rate on worldwide income
Aerospace	$2,282,317	$473,541	$2,755,858	$155,291	$172,943	$339,834	6.8	36.5	12.3
Beverages.....	1,186,983	885,719	2,072,702	342,251	346,457	688,708	28.8	39.1	33.2
Chemicals	3,116,500	2,707,400	5,823,900	154,300	1,545,800	1,700,100	5.0	57.1	29.2
Commercial banks	2,050,168	3,274,376	5,312,823	47,975	1,247,677	1,311,036	2.3	38.1	24.7
Crude oil production............	996,075	2,470,226	3,887,881	31,043	1,833,019	2,040,988	3.1	74.2	52.5
Diversified financials...........	1,653,911	238,357	2,282,168	277,816	93,645	399,161	16.8	39.3	17.5
Diversified services.....	1,714,074	951,309	2,522,970	507,179	319,152	693,958	29.6	33.5	27.5
Electronics, appliances.........	4,551,281	1,703,692	6,222,036	1,335,269	722,004	2,131,060	29.3	42.4	34.3
Food processors............	2,809,725	905,571	3,715,296	752,603	458,973	1,211,576	26.8	50.7	32.6

Table 2.—Federal Corporate Income Tax Rates of Selected Companies by Industry, 1981—Continued

[Dollar amounts in thousands]

Industry	U.S. income before tax	Foreign income [1] before tax	Worldwide income [2] before tax	Current U.S. tax expense	Current foreign tax expense [1]	Current worldwide tax expense	U.S. tax rate on U.S. income	Foreign tax rate on foreign income	World-wide rate on worldwide income
Industrial and farm equipment	1,594,768	438,395	2,033,163	383,574	177,167	560,741	24.1	40.4	27.6
Metal manufacturing	2,557,389	329,755	3,297,944	249,680	115,820	382,000	9.8	35.1	11.6
Motor vehicles	1,188,694	468,088	1,099,982	566,704	456,299	240,103	47.7	97.5	21.8
Office equipment	4,327,124	2,877,055	7,204,179	1,093,007	1,725,520	2,818,527	25.3	60.0	39.1
Oil and refining	21,489,584	19,737,334	47,638,253	4,003,997	11,913,965	18,092,162	18.6	60.4	38.0
Paper and wood products	1,354,143	197,959	1,552,102	(192,877)	57,339	(135,538)	(14.2)	29.0	(8.7)
Pharmaceuticals	1,692,049	1,280,600	2,972,649	606,782	619,915	1,176,697	35.9	48.4	39.6
Retailing	2,365,877	301,268	2,621,145	536,268	123,822	642,090	22.7	41.1	24.5
Tobacco	2,593,421	536,340	3,129,761	811,881	110,678	922,559	31.3	20.6	29.5

Transportation:									
Airlines	239,571	95,635	326,374	38,533	25,800	57,469	16.1	27.0	17.6
Railroads	1,723,273	([3])	1,723,273	(129,434)	([3])	(129,434)	(7.5)	([3])	(7.5)
Trucking	796,654	10,826	795,395	367,550	5,183	372,733	46.1	47.9	46.9
Utilities	15,375,821	204,521	16,202,651	1,417,224	83,024	1,514,037	9.2	40.6	9.3

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[1] Foreign income as disclosed in the financial statements may not reflect an allocation between foreign and domestic income that is consistent with U.S. tax rules. Current foreign tax expense may include amounts which are not creditable foreign taxes for purposes of the foreign tax credit under the applicable U.S. tax rules. For this and other reasons (such as foreign currency translation gains and losses), the foreign tax rate may not be comparable with the U.S. tax rate.

[2] Worldwide income is not necessarily the total of U.S. income and foreign income because some companies do not disclose foreign earnings and because losses are excluded from group totals. Thus, the worldwide tax rate does not necessarily fall between the U.S. and foreign tax rates.

[3] Not available.

The twenty large commercial banks included in the Pease-Dorgan Study had an average worldwide effective tax rate of 24.7 percent, a U.S. tax rate of 2.3 percent and a foreign tax rate of 38.1 percent.

The U.S. tax rates on U.S. income varied widely among industries, from a negative 14.2 percent for paper and wood products to 47.7 percent for motor vehicles. However, the rate for banks of 2.3 percent was lower than for any industry except paper and wood products (an industry which was severely depresssed in 1981) and railroads.

Worldwide tax rates also varied over a broad range from negative 8.7 percent for the paper and wood products industry to 52.5 percent for crude oil production. The worldwide tax rate of 24.7 percent for commercial banks was not markedly lower than for many other industries.

Effective tax rates of large commercial banks

The effective tax rates for each bank included in the commercial banks group in the Pease-Dorgan Study are shown in Table 3. Effective tax rates for the 10 largest banks are shown separately. These banks had a higher worldwide effective tax rate (30.3 percent compared with 24.5 percent) and U.S. effective tax rate (9.7 percent compared with 2.7 percent) than the group of 20 banks. (The totals in table 3 differ slightly from the table 2 totals primarily because table 3 totals include all 20 banks, while table 2 totals exclude banks with losses.)

Table 3.—Federal Income Tax Rates for 20 Large Commerical Banks, 1981

[Dollar amounts in thousands]

Bank	Worldwide			United States			Foreign		
	Income	Tax	Rate [1]	Income	Tax	Rate [1]	Income	Tax	Rate [2]
Bank America	$602,950	$169,000	28.0	$153,950	($18,000)	(11.7)	$449,000	$187,000	41.6
CitiCorp	778,917	405,000	52.1	(81,803)	15,000	(3)	860,720	390,000	45.3
Chase Manhattan	509,731	177,048	34.7	109,552	16,272	14.9	400,179	160,776	40.2
Manufecturers Hanover Trust	311,490	91,224	29.3	(38,497)	3,333	(3)	349,987	87,891	25.1
J. P. Morgan & Co	478,300	97,900	20.5	204,900	38,900	19.0	273,400	59,000	21.6
Continental Illinois	361,079	86,377	23.9	234,259	38,813	14.3	126,820	52,956	41.8
Chemical New York	230,916	55,249	23.9	138,462	4,400	3.2	92,454	50,849	55.0
First Interstate	245,910	18,100	7.4	206,910	12,100	5.8	39,000	6,000	15.4
Bankers Trust New York	244,970	61,509	25.1	45,258	(894)	(2.0)	199,712	62,403	31.2
First Chicago	142,509	22,100	15.5	103,209	200	.2	39,300	21,900	55.7
Subtotal	3,906,772	1,183,507	30.3	1,076,200	104,732	9.7	2,830,572	1,078,775	38.1
Security Pacific	311,788	28,176	9.0	264,916	6,184	2.3	46,872	21,992	46.9
Wells Fargo	145,778	17,613	12.1	52,778	2,808	5.3	93,000	14,805	15.9
Crocker National	68,645	8,397	12.2	7,997	(16,449)	(205.7)	60,648	24,846	41.0
Marine Midland	107,103	19,670	18.4	64,423	4,821	7.5	42,680	14,849	34.8
Mellon National	123,101	(22,106)	(18.0)	102,522	(39,757)	(38.8)	20,579	17,651	85.8
Irving Bank	123,368	15,362	12.5	65,461	1,074	1.6	57,907	14,288	24.7
Interfirst	186,000	31,000	16.7	163,000	29,000	17.8	23,000	2,000	8.7
First National Boston	151,981	41,293	27.2	65,591	(15,703)	(23.9)	86,390	56,996	66.0
Northwest Bancorp	98,577	(2,949)	(3.0)	(3)	(3)	(3)	(3)	(3)	(3)
First Bank System	81,874	(22,153)	(27.1)	69,146	(23,628)	(34.2)	12,728	1,475	11.6
Total	5,304,987	1,297,810	[2] 24.5	1,932,034	53,082	[2] 2.7	3,274,376	1,247,677	38.1

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[1] Percent (parenthetical indicates a negative rate).

[2] The average rate computed from this table differs from the Pease-Dorgan average rate. This difference is primarily due to the exclusion of loss companies from the Pease-Dorgan computations.

[3] Not disclosed, or not computed.

The U.S. tax rate for individual banks was either negative or varied over a relatively narrow positive range, from negative 205.7 percent (Crocker National, a refund on relatively low income) to 19.0 percent (J. P. Morgan & Co.). Only four banks (Chase Manhattan, J. P. Morgan & Co., Continental Illinois and Interfirst) showed U.S. tax rates on U.S. income greater than 8 percent. The worldwide tax rate on worldwide income varied over a broader range, from negative 27.1 percent (First Bank System) to 52.1 percent (Citicorp).

Table 3 also illustrates the source of income. For the 20 largest banks, 62 percent of their income was foreign source; for the 10 largest banks 72 percent was foreign source. For example, Citicorp had foreign source income of approximately $861 million, worldwide income of $779 million and a domestic loss of $82 million. Likewise Bankers Trust New York had $200 million in foreign income, $245 million worldwide income and domestic income of $45 million.

Large banks' effective tax rate of 24.7 on worldwide income is in large part due to the higher effective tax rates on foreign source income combined with the high percentage of total income that is foreign source. This has the effect of offsetting the low U.S. tax rate on U.S. income.

A comparison of the effective tax rates computed in the Pease-Dorgan Study with those in the Tax Notes Study and those disclosed in the corporate financial statements is shown in Table 4. The U.S. and foreign rates are not shown in financial statements and thus are not available for comparison.

First, in comparing the worldwide rates in the Pease-Dorgan Study with the rates in annual reports, it can be seen that, overall, the differences between these rates are relatively small. The average rate for the 20 banks is 27 percent in annual reports and 24.7 percent in the Pease-Dorgan Study. The main differences are attributable to the treatment of State and local income taxes (included in the annual report rate) and deferred taxes.

Second, the differences between the rates in the Pease-Dorgan Study and those in Tax Notes are more marked, with the rate in Tax Notes for almost every bank being lower. (The reasons for these differences are discussed more fully below.) The foreign tax rates in these studies are identical in many cases and very close in others. In Tax Notes the U.S. rate on U.S. income is negative in 11 out of the 19 banks which were included in the Tax Notes Study. The highest rate was J. P. Morgan & Co.'s rate of 7.9 percent, the only rate which was above 5 percent.

Since in the Pease-Dorgan Study deferred taxes and State and local taxes are excluded from the provision for income taxes, the effective tax rates are, as could be expected, generally lower than the effective tax rates disclosed in the financial statements. However, the effective tax rates computed by Tax Notes, which include a portion of deferred taxes, are generally even lower than the rates in the Pease-Dorgan Study. The reason for this somewhat unexpected result lies in the selection of timing differences that Tax Notes treats as quasi-permanent (and thus does not include in the tax rate) and those timing differences that result in deferred taxes that Tax Notes treats as actually paid.

Table 4.—Comparison of Effective Tax Rates for 20 Large Commercial Banks, 1981

Bank	Effective tax rates						
	Worldwide tax rate on worldwide income			U.S. tax rate on U.S. income		Foreign tax rate on foreign income	
	Annual report	Tax Notes	Pease-Dorgan study	Tax Notes	Pease-Dorgan study	Tax Notes	Pease-Dorgan study
Bank America	31.0	27.1	28.0	(15.4)	(11.7)	41.2	41.6
Citicorp	34.7	31.2	52.1	(2)	(2)	45.3	45.3
Chase Manhattan	26.9	18.1	34.7	(44.1)	14.9	31.6	40.2
Manufacturers Hanover Trust	33.2	16.4	29.3	(2)	(2)	24.4	25.1
J. P. Morgan & Co.	32.3	17.6	20.5	7.9	19.0	23.8	21.6
Continental Illinois	31.8	19.7	23.9	3.9	14.3	48.7	41.8
Chemical New York	27.9	4.7	23.9	(14.9)	3.2	65.2	55.0
First Interstate	11.0	3.2	7.4	1.0	5.8	15.4	15.4
Bankers Trust New York	24.0	7.6	25.1	(92.4)	(2.0)	30.6	31.2
First Chicago	18.3	11.1	15.5	(6.3)	.2	55.5	55.7
Security Pacific	37.6	5.5	9.0	(2.2)	2.3	46.9	46.9
Wells Fargo	21.0	(8.6)	12.1	(61.3)	5.3	20.1	15.9
Crocker National	9.6	37.2	12.2	(1,786.3)	(205.7)	41.0	41.0
Marine Midland	31.3	15.0	18.4	1.8	7.5	34.8	34.8
Mellon National	12.3	(4.4)	(18.0)	(22.6)	(38.8)	85.8	85.8
Irving Bank	28.2	11.9	12.5	.2	1.6	24.7	24.7
Interfirst	26.0	(1)	16.7	(1)	17.8	(1)	8.7
First National Boston	33.4	25.2	27.2	(23.8)	(23.9)	66.5	66.0
Northwest Bancorp	3.6	3.3	(3.0)	(1)	(1)	(1)	(1)
First Bank System	1.6	(16.4)	(27.1)	(20.6)	(34.2)	11.6	11.6

[1] Information not available or not disclosed.

[2] No rate is computed on book loss.

Timing differences treated as quasi-permanent by Tax Notes include accelerated depreciation primarily from leasing activities and some loan losses. These particular timing differences result in a deferred tax expense for most of the banks studied. Thus, the effect of excluding these items from the effective tax rate is a lower rate than that disclosed in financial statements, which is the same result as in the Pease-Dorgan Study. However, the Tax Notes rate is further reduced by the inclusion of timing differences which, in the case of those particular banks, result in a deferred tax credit (i.e., they reduce the overall tax rate). These timing differences either originated in an earlier period and are now reversing or result from transactions giving rise to income which is recognized for tax purposes sooner than it is for financial statement purposes. These timing differences appear to include some loan losses, cash to accrual adjustments, installment sales, undistributed earnings of foreign subsidiaries, foreign currency translation, foreign tax credits, investment tax credits and others.

Analysis of permanent differences

Table 5 shows the permanent differences identified in the reconciliation of effective tax rates to the statutory rate in the financial statements.

Clearly, the most significant permanent difference for banks is the interest received on State and local government obligations, which is included as income for financial accounting purposes but is excluded from taxable income. Tax exempt income reduced the effective tax rate by amounts which varied from 5.6 percent (Citicorp) to 47.3 percent (First Bank System). For fifteen of the twenty banks, the reduction in effective tax rates was greater than 15 percent.

Other permanent differences that affect banks are often grouped as "other" where each item included is not material by itself. These differences are in general similar to permanent differences for other corporations.

Reductions in tax rates from the statutory rate also arise from provisions in the tax rules which tax some income at a different rate than other income, or from income tax credits. Examples of income taxed at lower rates include the first $100,000 of taxable income, which is taxed at graduated rates below 46 percent. Additionally, income resulting in capital gains is taxed at a lower rate. Income tax credits include the investment tax credit, targeted jobs tax credit and others. Investment tax credits can result in a significant reduction of tax rates for any bank that is engaged in substantial leasing activities.

Table 5.—Reconciliation to Statutory Federal Income Tax Rate Per Financial Statements for 20 Large Commercial Banks, 1981

Bank	Statutory rate	Tax exempt income	Investment tax credit	Other	Effective tax rate per annual report[1]
Bank America	46.0	(7.0)	(6.0)	(6.0)	27.0
Citicorp	46.0	(5.6)	(2)	(7.0)	33.4
Chase Manhattan	46.0	(17.2)	(2)	(5.2)	23.6
Manufacturers Hanover Trust	46.0	(15.2)	(2)	(6.4)	24.4
J. P. Morgan & Co.	46.0	(19.9)	(2)	(.5)	25.6
Continental Illinois	46.0	(13.1)	(2)	(2.9)	30.0
Chemical New York	46.0	(18.7)	(2)	(6.1)	21.2
First Interstate	46.0	(32.0)	(5.0)	(1.0)	8.0
Bankers Trust New York	46.0	(19.0)	(2)	(4.0)	23.0
First Chicago	46.0	(21.8)	(2.3)	(5.6)	16.3
Security Pacific	46.0	(6.0)	(5.3)	(2.2)	32.5
Wells Fargo	46.0	(14.4)	(6.9)	(3.7)	16.9
Crocker National	46.0	(23.9)	(16.4)	(1.4)	4.3
Marine Midland	46.0	(15.8)	(3.0)	(1.8)	25.4
Mellon National	46.0	(31.1)	(2)	(2.6)	12.3
Irving Bank	46.0	(18.9)	(2)	(4.8)	22.3
Interfirst	46.0	(18.6)	(.7)	(.7)	26.0
First National Boston	46.0	(16.6)	(.3)	(1.2)	27.9
Northwest Bancorp	46.0	(39.2)	(4.9)	(2.3)	(.4)
First Bank System	46.0	(47.3)	(3.0)	(2)	(4.3)

[1] Excludes portion attributable to State and local taxes.
[2] Not available or not disclosed.

In accounting for investment tax credits, special rules apply to financial institutions. A financial institution may include the investment tax credit as part of the proceeds from leased property accounted for by the financing method and include it in determining the yield from the loan, which is reflected in income over the term of the lease. Under this method of financial accounting for investment tax credits, the provision for taxes will not be decreased but, instead, income will be increased by the amount of the investment tax credits. Therefore, the effective tax rate calculations will show the bank paying more tax (but earning more income) than it actually does. However, the amount of investment tax credit amortized to lease income is not always disclosed; therefore, the distortion in effective tax rates due to this method of accounting for the investment tax credit cannot always be determined. Investment tax credits accounted for in this manner will not be reflected in the reconciliation to statutory rates.

When a bank purchases property for its own use, the investment tax credit on this property can reduce taxes for book purposes in the same year as for tax purposes (flow-through method) or over the life of the asset (deferral method). If the flow-through method is used, the investment tax credit will be reflected as a reduction in tax rate in the same manner as a permanent difference. If the deferral method is used, the amount deferred for book purposes will be reflected as a timing difference. Investment tax credits which are disclosed separately reduce the effective tax rate by as much as 16.4 percent (Crocker National).

Analysis of timing differences

Table 6 shows the timing differences identified in the analysis of deferred tax included in the financial statements. This section discusses some of the more significant of these timing differences.

Leasing.—First, some significant timing differences are attributable to the accounting for lease financing activities. Such timing differences arise primarily from the use of accelerated cost recovery for tax purposes and straight-line depreciation for financial accounting purposes. These timing differences generally result in a deferred tax expense (i.e., an expense treated as a current year's expense for book purposes although it will not actually be payable until some future date). To the extent that a financial institution increases leasing activities or there is inflation, these deferred taxes may be deferred indefinitely. However, if the leasing activities are reduced, these timing differences will reverse (deferred tax will be a credit), and the tax liability will be paid.

Table 6.—Analysis of Deferred Tax Per Financial Statements for 20 Large Commercial Banks, 1981

[Percent]

Bank	Effective tax rate per annual report [1]	Rate reduction due to deferred tax [2]						Deferral of State and local tax	Effective tax rate per Pease-Dorgan study
		Loan loss	Lease financing	Foreign	Accrual to cash [5]	ITC	Other [3]		
Bank America	27.0	(3.9)	(10.3)	3.2	([4])	11.7	(0.4)	0.7	28.0
Citicorp	33.4	8.9	(5.1)	6.3	2.6	([4])	6.0	(.3)	52.1
Chase Manhattan	23.6	.7	(3.9)	6.2	2.1	([4])	3.1	2.9	34.7
Manufacturers Hanover Trust	24.4	7.0	(10.2)	4.5	([4])	([4])	4.8	(1.2)	29.3
J. P. Morgan & Co.	25.6	2.5	(7.8)	([4])	([4])	([4])	(5.3)	5.5	20.5
Continental Illinois	30.0	3.8	(5.1)	([4])	([4])	(5.8)	.9	.1	23.9
Chemical New York	21.2	1.5	(6.5)	([4])	4.2	([4])	5.1	(1.6)	23.9
First Interstate	8.0	3.7	(6.4)	([4])	3.8	([4])	.3	(2.0)	7.4
Bankers Trust New York	23.0	(.7)	(14.0)	([4])	([4])	([4])	15.3	1.5	25.1
First Chicago	16.3	(6.7)	(5.9)	([4])	3.0	[6] 9.0	(2.2)	2.0	15.5
Security Pacific	32.5	(2.2)	(24.7)	([4])	([4])	3.6	(3.9)	3.7	9.0
Wells Fargo	16.9	5.7	(20.6)	([4])	16.4	([4])	(7.7)	1.4	12.1
Crocker National	4.3	11.7	(30.8)	([4])	(30.5)	[6] 52.8	(3.7)	8.4	12.2
Marine Midland	25.4	2.8	(5.6)	([4])	([4])	(2.7)	(1.6)	.1	18.4
Mellon National	12.3	(13.4)	(10.1)	([4])	.4	([4])	(7.2)	([4])	(18.0)
Irving Bank	22.3	1.8	(8.5)	([4])	([4])	([4])	(5.2)	2.1	12.5
Interfirst	26.0	(1.1)	(4.8)	([4])	([4])	([4])	[7] (3.4)	([4])	16.7

Table 6.—Analysis of Deferred Tax Per Financial Statements for 20 Large Commercial Banks, 1981

[Percent]

Bank	Effective tax rate per annual report [1]	Rate reduction due to deferred tax [2]						Deferral of State and local tax	Effective tax rate per Pease-Dorgan study
		Loan loss	Lease financing	Foreign	Accrual to cash [5]	ITC	Other [3]		
First National Boston	27.9	4.5	.2	(6.3)	4.4	([4])	(2.8)	(.7)	27.2
Northwest Bancorp	(.4)	.4	(7.4)	7.6	([4])	([4])	(5.5)	2.3	(3.0)
First Bank System	(4.3)	1.7	(7.7)	([4])	([4])	([4])	[7] (20.6)	3.8	(27.1)

[1] Excludes portion attributable to State and local taxes.

[2] A deferred income/expense item which reduces the current year's tax liability is shown as a reduction in effective rates (negative amount) in the above table.

[3] Includes adjustments to income and tax expense made in the Pease-Dorgan Study. For an explanation of these adjustments, see Methodology and Appendix A in Pease-Dorgan Study.

[4] Not available.

[5] Includes amounts attributable to different methods of accounting for book and tax purposes.

[6] Includes foreign tax credit carryovers.

[7] Adjustment includes effect of tax refund attributable to securities losses (not included in annual report effective rate).

Nineteen of the twenty large banks benefited from the deferrals due to lease financing. The resulting reduction in effective tax rates ranged from 30.8 percent (Crocker National) to 3.9 percent (Chase Manhattan). Seven banks (Bank America, Manufacturers Hanover Trust, Bankers Trust New York, Security Pacific, Wells Fargo, Crocker National, and Mellon National) reduced their effective tax rates by more than 10 percent due to their leasing activities.

Loan-loss reserves.—Second, other timing differences are attributable to the provision for losses on loans. Under generally accepted accounting principles, the convention of conservatism requires that, when assets are measured in a context of significant uncertainties, possible errors in measurement should be in the direction of understatement. Thus, the reserve for losses on loans is based on an evaluation of anticipated loan losses. The methods used to compute loan loss reserves for tax purposes generally do not result in the same addition to a reserve for loan losses as that computed for accounting purposes. Thus, the bad debt expense is allowed as a deduction in different years for book and for tax purposes, giving rise to timing differences.

For some of the banks included in the Pease-Dorgan Study, the bad debt deduction allowed for taxes was higher than that allowed for book purposes, giving rise to a deferred tax expense which reduced the current year's income tax liability. The amount of the reduction ranged from 13.4 percent (Mellon National) to 0.7 percent (Bankers Trust New York). For other banks, the bad debt deduction allowed for tax purposes was lower than that allowed for book purposes, giving rise to deferred taxes which reflect a higher current year's tax liability than book liability. Effective tax rates were increased by 11.7 percent (Crocker National) to 0.4 percent (Northwest Bancorp).

Typically, in years prior to 1981 the additions to the loan loss reserves for book purposes were lower than those allowed for tax purposes. In those years banks had the benefit of the tax deferral. More recently, during a period of economic uncertainty, the additions to the loan loss reserves for book purposes, determined under management's best judgement of expected loan recovery rates, have often been greater than the amounts allowed for tax purposes.

Foreign items.—Third, some timing differences are attributable to foreign operations. These include the undistributed earnings of foreign subsidiaries, foreign currency translation and foreign tax credits.

Deferred taxes need not be provided on undistributed earnings of subsidiaries when sufficient evidence shows that the subsidiary has invested, or will invest, the undistributed earnings indefinitely or that earnings will be remitted in a tax-free liquidation. In this case, the books reflect the deferral of taxes that exists under the tax rules as a permanent difference. However, if the earnings are not deemed to be invested indefinitely, deferred taxes must be provided.

Foreign currency translation gains or losses may be included in income, and foreign tax credits may be recognized, for financial statement purposes in a different period than for tax purposes.

Deferred taxes attributable to foreign operations of banks included in the Pease-Dorgan Study have been grouped together (see Table 6). In total, the change in effective tax rates ranged from a decrease in rate of 6.3 percent (First National Boston) to an increase in rate of 7.6 percent (Northwest Bancorp). Overall, these items do not have a major impact on the effective tax rates.

Method of accounting.—Fourth, some timing differences are attributable to a taxpayer using the accrual method of accounting for book and the cash method of accounting for tax purposes. Some large, and many smaller, financial institutions use the cash method of accounting for tax purposes.

Accrual-to-cash timing differences arise when items of income or expense are recognized or allowed as a deduction in different periods. In general, many of these timing differences originate in one period and reverse in the next period. While in aggregate accrual-to-cash timing differences may provide some deferral of tax, this deferral is not generally an indefinite deferral such as the deferral attributable to accelerated cost recovery.

Other differences.—Fifth, all other timing differences are grouped together. Each timing difference included may not be material by itself. For purposes of Table 6, the adjustments made in the Pease-Dorgan Study are also grouped with "other differences". These adjustments were needed primarily to ensure that the accounting entity was comparable with the tax entity because the accounting rules for grouping corporations together are not the same as the tax rules. On average, the impact of these adjustments on the effective tax rate was not material.

C. Significance of Effective Tax Rates

The previous section noted a number of unresolved issues that arise in trying to measure the effective tax rates of commercial banks from data in financial statements. Apart from these somewhat technical questions, there are some more fundamental questions about the significance of the resulting measures of effective tax rates.

Perceptions of tax equity

One issue that arises when an industry pays relatively low effective tax rates is that individuals may conclude that the tax system is not equitable. This may cause them to reduce their own level of compliance with the tax laws, avail themselves of more opportunities to make tax-sheltered investments, urge their legislators to enact countervailing tax preferences for themselves, or simply cause the American people to lose faith in the political process. These perception problems may be particularly acute when an industry is highly visible, like the banking industry, and is an industry whose interactions with the citizenry are sometimes adverse (e.g., loan foreclosures and high interest costs for loans).

True burden of taxation

One deficiency of the effective tax rate concept is that it does not distinguish between the income tax burden imposed directly on a taxpayer (in the case of the banks, a relatively modest burden in 1981) and the ultimate economic burden that the income tax places on a person. The economic burden of the income tax on banks is considerably higher than the actual tax they owe. The reason for this is that many of the tax-preferred investments made by banks, including equipment leases and tax-exempt bonds, yield lower pre-tax rates of return than do fully taxable but otherwise comparable investments. This lower pre-tax rate of return constitutes a burden attributable to the income tax on banks that is not reflected in effective tax rate measures based on taxes actually paid.

The extent to which this indirect burden causes the total burden on banks to approach the 46-percent statutory tax rate depends on the difference between the after-tax yields of tax-preferred investments and fully taxable investments. If the difference in after-tax yields is small, it indicates that the banks bear close to the full economic burden of the income tax with respect to the tax-preferred investments.

For some tax-preferred investments, this appears to be the case. For example, in the case of tax-exempt bonds with relatively short maturities, interest rates are sufficiently lower than on comparable taxable bonds that the after-tax return on the tax-exempt bonds is not appreciably higher. Thus, even though holders of these bonds pay no tax on the income, they bear a burden comparable to the full 46-percent income tax. In effect, the banks in this case are relatively efficient conduits through which the federal government routes its assistance for short-term borrowing by State and local governments.

However, the issue is more clouded in the case of longer-term tax-exempt bonds. The interest rates on these bonds in recent months have been 75 to 85 percent of those on comparable taxable bonds, so that banks have earned a higher after-tax rate of return on them than on taxable bonds. (The tax-exempt interest rate would have to be 54 percent of the taxable rate for the banks to be bearing a full 46-percent indirect burden.) Thus, with respect to these investments, the banks bear some burden but considerably less than the full 46 percent. In effect, the banks are a conduit through which the federal government routes its subsidy for long-term borrowing to State and local governments and other beneficiaries of tax-exempt financing, but they are a relatively inefficient conduit. For example, at an interest rate ratio of 80 percent, the issuing government receives only 43 percent of the federal interest subsidy and the banks receive 57 percent.

The other principal area in which the banks act, in effect, as conduits for the delivery of federal assistance through the tax system is equipment leasing. It is widely known that leasing enables some of the value of tax benefits to be passed through to lessees through lower lease rentals; however, unlike the situation with tax exempt bonds, no data are available on what fraction of the benefits are passed through. (A Joint Committee staff study on safe-harbor leasing[1] concluded that 77 percent of the benefits were passed through to lessees, but no comparable study is available for ordinary leasing.)

Reserve requirements

The banks argue that their actual tax payments understate the contribution they make to federal budget receipts because the Federal Reserve System earns interest on reserves which banks and thrift institutions are required to keep at the Fed. The Fed pays no interest on these reserves, and when the Fed deposits its earnings at the Treasury, the budget records additional budget receipts. However, others argue that reserve requirements, to the extent they can be considered analogous to a tax, are closer to an excise tax than to an income tax and, therefore, should not be counted as a component of an effective income tax rate. Furthermore, it is argued that many businesses have to deal with government regulations and that discussions of effective tax rates would be confused if adjustments were made for the burden of such regulations (e.g., the effect of natural gas price controls on the oil and gas industry).

Allocation of resources

Some have argued that the low effective tax rates paid by banks provide an incentive for the economy to invest too much of its limited stock of capital in the banking industry, as opposed to investing in other kinds of industries. However, it would be very difficult to quantify this effect.

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[1] "Analysis of Safe Harbor Leasing," a report by the staff of the Joint Committee on Taxation, June 14, 1982 (JCS-23-82).

III. SPECIFIC TAX LAW PROVISIONS

A. Bad Debt Reserves

Present Law

General tax rules

Under present law, taxpayers are permitted a deduction for any debt which is acquired or incurred in the taxpayer's trade or business which becomes wholly or partially worthless during the taxable year. This deduction may be computed under either of two methods. Under the "specific charge-off method" specific bad debts may be deducted in the year in which they become worthless or partially worthless. Under the "reserve method" a deduction is permitted, at the discretion of the Secretary, for a reasonable addition to a reserve for bad debts. When debts are determined to be totally or partially worthless, no deduction is allowed, but the amount of the bad debt is charged against the reserve (i.e., the reserve is reduced). The taxpayer's method of computing the annual addition to the bad debt reserve will allow him to deduct an amount needed to increase the reserve to the appropriate level. The reasonableness of an addition to a reserve for bad debts depends upon the facts and circumstances of the particular case as they exist at the close of the taxable year of the proposed addition to the reserve. The courts have generally permitted taxpayers to determine the reasonable addition to the reserve for bad debts under a formula similar to the experience method for banks, described below.

Commercial banks

Commercial banks may use several methods of computing bad debt reserves. A commercial bank is allowed a deduction for an annual addition to its loan loss reserves [1] equal to the greater of the amounts computed under either the "experience" or "percentage of eligible loan" method.[2]

Experience method.—Under the experience method, the addition to the reserve for bad debts is generally an amount necessary to increase the loan loss reserve at the close of the taxable year to a percentage of total loans outstanding equal to the average ratio of total bad debts in the current and 5 preceding taxable years to the sum of loans outstanding at the close of these years. However, if it leads to a larger loss reserve, the annual allowable addition is the amount necessary to increase the balance of the loan loss reserve to the balance of the reserve at the close of the base year (or if the total amount of loans outstanding at the close of the taxable year is less than the loans outstanding at the close of the base year, a proportionate part of the loans outstanding at the close of the taxable year). Presently, the base year is the last taxable year before the most recent adoption of the experience method. Taxpayers may use an averaging period shorter than 6 years with the approval of the Treasury, which may be given in the cases where the taxpayer can demonstrate that there has been a change in the type of a substantial portion of the loans outstanding such that the risk of loss is substantially increased.

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[1] Unlike the funded reserve that many financial institutions are required to maintain under the auspices of various regulatory bodies, a reserve for bad debts for tax purposes consists simply of accounting entries in the institution's books and records (i.e., it is not a funded reserve of cash or other liquid assets available to offset the impact of unexpected losses).

[2] Commercial banks also are permitted to use the specific charge-off method in lieu of the reserve method. However, few banks presently use the specific charge-off method.

After 1987, commercial banks are required to compute the deduction for additions to the reserve for bad debts solely under the experience method (or specific charge-off method).

Percentage of eligible loans method.—Under the "percentage of eligible loans" method, an addition to the reserve for bad debts is allowable in an amount sufficient to increase the loan loss reserve at the close of the taxable year to a specified percentage of the eligible loans at the close of the taxable year.[3] The specified percentage was 1.0 percent for 1982 and is 0.6 percent for 1983 through 1987. Thus, in the case of a bank whose eligible loan portfolio is expanding and which starts the year with a 0.6-percent bad debt reserve, the deduction for the addition to the bad debt reserve in a typical year will be the actual bad debt losses charged against the reserve during that year plus 0.6 percent of the increase in eligible loans during the year.

As is the case under the experience method, commercial banks utilizing the percentage of eligible loans method are permitted, at a minimum, a deduction sufficient to restore the balance in the loan loss reserve at the close of the taxable year to its base-year level so long as eligible loans have not decreased below their base-year level.[4] If eligible loans have decreased below their base-year level, the minimum bad debt deduction permitted the bank will be reduced proportionately.[5] In addition, the maximum addition to the reserve for losses on loans under the percentage method cannot exceed the greater of 0.6 percent of eligible loans outstanding at the close of the taxable year or an amount sufficient to increase the reserve for losses on loans to 0.6 percent of eligible loans at such time.

A commercial bank may switch between methods of determining the addition to its reserve for losses on loans from one year to another. Further, a commercial bank need not adopt a method yielding the largest deduction, although the regulations do prescribe minimum deductions.

Under present law, if the bad debt reserve deduction for the taxable year determined under the above rules exceeds the amount which would have been an allowable deduction on the basis of actual experience, the allowable bad debt reserve deduction for the taxable year is reduced by 15 percent of the excess. Further, 71.6 percent of the excess is an item of tax preference under the minimum tax.

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[3] For purposes of the percentage computation, the term "eligible loans" generally means loans incurred in the course of the normal customer loans activities of the financial institution, on which there is more than an insubstantial risk of loss. In determining the allowable addition to reserves under the experience method, there is no requirement that the computation be based on eligible loan balances.

[4] For purposes of the percentage of eligible loans method, after 1982 the base year will generally be 1982.

[5] There is a further limitation that reduces the bad debt addition when the base-year loss reserve is less than the allowable percentage of base-year loans.

Thrift institutions

Under present law, thrift institutions (mutual savings banks, domestic building and loan associations, savings and loan associations, and cooperative banks without capital stock) are granted more favorable tax treatment in the computation of their bad debt deductions than that generally allowed to other taxpayers. Presently, thrift institutions are allowed to compute the deductible additions to their bad debts reserves under modified versions of either of the two methods available to commercial banks (i.e., the experience method or the percentage of eligible loans method), or under the "percentage of taxable income" method. They may also use the specific charge-off method.

In determining the amount of an allowable loan loss deduction, special rules apply with respect to "qualifying real property loans" and "nonqualifying loans." In general, a qualifying real property loan is any loan secured by an interest in improved real property or secured by an interest in real property that is to be improved out of the proceeds of the loan, A nonqualifying loan is any loan which is not a qualifying real property loan.

Experience method.—Under the experience method, a thrift institution is allowed a deduction equal to a reasonable addition to its loan loss reserve, determined under the experience method applicable to commercial banks.

Percentage of eligible loans method.—Under the percentage of eligible loans method, a thrift institution is allowed an addition to its loan loss reserve for losses on qualifying real property loans computed in the same manner as the addition for losses on eligible loans is computed for commercial banks plus the allowable addition to the loan loss reserve for nonqualifying loans computed under the experience method. However, the overall loss reserve is limited to the larger of (1) the amount determined under the experience method applicable to commercial banks, or (2) an amount which equals the excess of 12 percent of total deposits or withdrawable accounts of depositors at the close of the taxable year over the sum of the institution's surplus, undivided profits and reserves at the beginning of such taxable year. (This limit applies to the percentage of taxable income method as well.) In effect, thrift institutions using the percentage methods may not build up a loan loss reserve such that their loan loss reserve plus their surplus exceeds 12 percent of deposits. Thrift institutions which have little or no taxable income usually elect this method of computing their bad debt reserves.

Percentage of taxable income method.—Under the percentage of taxable income method, a thrift institution is allowed a deduction for additions to its loan loss reserve for qualifying real property loans equal to 40 percent of its "taxable income" for the taxable year.[6] A variety of limitations are, however, placed on this addition. First, the percentage of taxable income which may be deducted under this method (presently 40 percent) is reduced by ¾ percentage points for each percentage point by which "qualifying assets" fall short of 82 percent of total assets (1½ percentage points for each percentage-point shortfall below 72 percent in the case of a mutual savings bank without stock).[7] Second, the percentage-of-taxable-income method is not applicable at all if less than 60 percent of the institution's total assets are invested in qualifying assets. Third, the amount determined under the percentage of taxable income method must be reduced by a proportional amount of the loan loss reserve addition for that taxable year determined under the experience method with respect to nonqualifying loans. Fourth, the addition to the reserve for qualifying real property loans may not exceed the amount necessary to increase the balance of such reserve at the close of the taxable year to 6 percent of such loans outstanding at the close of the taxable year. Finally, the overall bad debt reserve addition cannot exceed the greater of (1) the amount determined under the experience method described above for commercial banks, or (2) the excess of 12 percent of total deposits or withdrawable accounts of depositors at the close of the taxable year over the sum of surplus, undivided profits, and reserves at the beginning of the taxable year.

As in the case of commercial banks, the excess of the amount allowable to the thrift institution as a reasonable addition to its bad debt reserve for the taxable year, over the amount that would be allowable for that taxable year had the institution maintained its reserve on the basis of actual experience for all taxable years, is a financial institution preference item. As such, 15 percent of the excess is nondeductible and 71.6 percent of such excess is an item of tax preference subject to the minimum tax.

Because the effect of the percentage of taxable income method is to subject thrift institutions to tax only on part of their income, limitations are imposed upon some of the deductions and credits of thrift institutions. First, thrift institutions are entitled to only one-half of the investment tax credit available to other taxpayers generally. Second, thrift institutions are entitled to only one-half of the targeted jobs tax credit available to other taxpayers generally. Finally, although corporations generally are entitled to a deduction of 85 percent (100 percent in certain circumstances) of all dividends received from domestic corporations, thrift institutions must reduce the amount of this deduction by 40 percent. These provisions that deny tax benefits to thrift institutions apply regardless of whether the institutions actually use the percentage-of-taxable-income method and are independent of the amount of the benefit they receive from use of that method.

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[6] The term "taxable income" is defined for this purpose to mean taxable income computed by excluding amounts recaptured by thrift institutions out of excess loan loss reserves, without regard to amounts deductible as an addition to the bad debt reserve, by excluding from gross income amounts of net gain on the sale or exchange of corporate stock or tax-exempt bonds, by excluding 18/46 of other net long-term capital gains and by excluding intercorporate dividends received to the extent a deduction is allowable.

[7] "Qualifying assets" for this purpose are: (a) cash, (b) taxable Government obligations, (c) obligations of State-chartered organizations which are organized to insure deposits or share accounts of member associations, (d) share loans, (e) loans for residential real property, including real property primarily used for church purposes, facilities in residential developments dedicated to public use (e.g., schools and libraries), and property used on a nonprofit basis by residents (e.g., swimming pools, etc.) and mobile homes not used on a transient basis, (f) loans for the improvement of commercial or residential property in an urban renewal area or in an area eligible for assistance under the Demonstration Cities and Metropolitan Development Act, (g) loans for educational, health and welfare institutions or facilities including facilities primarily for students, residents, etc., (h) property acquired through the liquidation of any of the prior three categories, (i) student loans, and (j) property used by the thrift institution in its business.

Legislative History

Commercial banks

Prior to 1969, bad debt reserves of commercial banks were determined under administrative rulings. Prior to 1965, banks were allowed to accumulate a reserve of up to three times the 20-year average of their losses as a percentage of loans. In 1965, the Treasury Department granted banks the privilege, on an industry-wide basis, of building up a bad-debt reserve equal to 2.4 percent of eligible loans.

The Tax Reform Act of 1969 established the basis of the present system of computing bad debt reserves of commercial banks. The percentage of eligible loans method was phased out over an 18-year period. At that time, it was asserted that bad debts averaged only about 0.2 percent of outstanding noninsured loans.

In the Economic Recovery Tax Act of 1981, the phase-down of the percentage from 1.2 to 0.6 was delayed from 1982 to 1983, and a percentage of 1.0 established for the year 1982. The Tax Equity and Fiscal Responsibility Act of 1982 reduced the excess bad debt reserve deduction of both banks and thrift institutions by 15 percent as part of an across-the-board cutback in tax preferences.

Thrift institutions

Savings and loan associations, cooperative banks and mutual savings banks were tax exempt until the Revenue Act of 1951. While thrift institutions were made taxable as part of that Act, they were also given generous bad debt deductions that kept their taxes to a small fraction of income. In the Revenue Act of 1962, Congress attempted to end this virtual tax exemption by modifying the bad debt reserve deductions.

The system set up in 1962 allowed thrift institutions to choose among two alternative formulas: (1) an annual addition to reserves of 60 percent of taxable income (limited to a loss reserve of 6 percent of qualifying real property loans), or (2) a loss reserve of 3 percent of qualifying real property loans plus a percentage of other loans based on experience. Savings and loan associations and cooperative banks were allowed to use these methods only if 82 percent of their assets were invested in residential real estate, liquid assets and certain other assets, but no similar restrictions were applied to mutual savings banks.

The basis of the present system was set up by the Tax Reform Act of 1969, which eliminated the 3-percent method, phased down the percent of taxable income from 60 to 40 percent over 10 years, applied limits on the use of the percentage of taxable income method to mutual savings banks similar to those applicable to savings and loan associations (but with a 72-percent qualifying asset requirement in place of 82 percent), provided that the taxable income percentage was to be phased down gradually if an institution's proportion of qualifying assets fell short of 82 or 72 percent (instead of causing that institution to lose all benefit from the percentage of taxable income method), and made a series of other modifications to the bad debt provisions.

The Economic Recovery Tax Act of 1981 expanded the organizations eligible for these special rules to include stock savings banks. The rules applicable to stock savings banks are the same as those applicable to savings and loan associations.

Issues

The principal policy issues related to the bad debt reserves of financial institutions can be grouped under two headings: (1) what treatment of bad debts provides an accurate measure of a taxpayer's income, and (2) to the extent that Congress wants to provide deductions in excess of those needed to measure income in order to achieve some nontax policy objectives, what treatment of bad debts would best carry out Congressional intent?

Income measurement

Since 1921, all businesses have been allowed to deduct additions to bad debt reserves; that is, to accumulate a bad debt reserve out of pre-tax, rather than after-tax, income. The argument that the reserve treatment of bad debts (as opposed to the specific charge-off method) contributes to proper income measurement runs essentially as follows: When a business makes sales that are reflected in accounts receivable, and reports the sales as taxable income, it knows that statistically a certain percentage of those receivables are likely to become bad debts. According to the principles of accrual basis accounting, the cost of the bad debts is allocable to, and properly deductible against, the sales which generated those receivables, and thus some estimate of their cost should be deducted as an addition to bad debt reserves when the income from the sales is reported. When actual defaults occur, under this theory the bad debts should first be charged against the bad debt reserve and should only be deductible to the extent they exceed the amount previously deducted as an addition to the bad debt reserve.

Under present law, a widely accepted method of determining a reasonable addition to a reserve for bad debts is an experience method as described in the case of *Black Motor Co.*[8] The *Black Motor Co.* case adopted a six year moving average method for determining a business' addition to its bad debt reserve. This rule generally was adopted statutorily as one method for determining a financial institution's annual addition to its loan loss reserve.

There has been criticism of the *Black Motor Co.* method as it applies to an ordinary business because it only produces the theoretically correct reserve addition (i.e., the amount that would be deductible according to the principles of accrual accounting stated above) under a rather strict set of assumptions, the principal ones being that losses are charged off promptly, future losses equal a 6-

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[8] *Black Motor Co., Inc. v. Commissioner*, 41 B.T.A. 300 (1942); see, *Thor Power Tool Co., v. Commissioner*, 439 U.S. 522 (1979).

year moving average of past losses, and that receivables turn over once a year.[9] Suggestions have been made on how the experience method might be adjusted to deal with some of these problems. These include mechanical adjustments to the formula to adjust for turnover, as well as making it easier for taxpayers to make a "facts and circumstances" showing that their 6-year moving average loss rate is not a good estimate of future losses. It is not clear, however, that bad debt deductions for most ordinary businesses are sufficiently important to warrant the complexity associated with fine-tuning the Black Motor formula.

Some banks have argued that these same principles should apply to accounting for their bad debts but that bad debts are so important for their business that the deficiencies of the experience method should be corrected, such as by permitting more liberal use of "facts and circumstances" deviations from the 6-year moving average formula. Alternatively, it has been suggested that Congress set up a sufficiently generous statutory formula, such as 1.0 percent of eligible loans. Banks have argued that a one-percent formula would approximate the size of bad debt reserves for book purposes in recent years.

However, the application of accrual accounting principles to banks does not necessarily lead to the conclusion that their bad debt reserves should be computed under the formula that theoretically should be applicable to the accounts receivable of an ordinary business. Consider, for example, a bank that makes 100 loans, each amounting to one dollar and each maturing in 3 years. Assume that it anticipates that 5 percent of the loans will not be repaid, and it charges sufficiently high interest rates on all 100 loans to make them profitable despite the 5-percent expected default rate. One interpretation of the principles of accrual accounting is that the $5 bad debt expense be spread over the period during which the income from the loans will be earned; that is, one-third of it should be approximated by some type of bad debt reserve deduction each year. This is not the same as the formula appropriate for the receivables of an ordinary business. The difference is that the creation of receivables is usually the by-product of an event that produces taxable income against which all the bad debt losses from those receivables should be matched in an accrual method of accounting. Banks, however, generate bad debts from lending, and it is the interest from the loans that is the income against which bad debt losses should be matched, not the loans themselves. However, others argue that a more conservative treatment of expected bad debt losses is more appropriate for the banking industry, such as accounting for the entire expected bad debt loss in the year the loan is made. The issue of how best to determine an experience-based bad debt reserve is a complicated one, and Congress may want to study possible technical modifications of the present experience method prior to its becoming the required method for banks in 1988.

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[9] Assume, for example, that a business sells $100 of goods per year and generates $100 of receivables per year, $95 of which are paid after one year and $5 of which are bad debts. Under present law, the taxpayer will be able to build up a bad debt reserve equal to $5, the theoretically correct amount. Suppose, however, that receivables turn over twice a year (i.e., sales of $200 per year with receivables paid every 6 months), in which case bad debt losses will be $10 each year but outstanding debts at yearend will still be $100. Under the experience method, the taxpayer will be allowed to accumulate a bad debt reserve equal to 10 percent of receivables ($10 annual average losses divided by $100 annual average yearend receivables), or $10. This clearly exceeds the theoretically correct amount, which is still 5 percent of receivables, or $5. Conversely, the experience method leads to too small a reserve when receivables turn over less frequently than once a year. For examples on how the experience method produces incorrect results in other cases, see Whitman, Gilbert and Picotte, "The Black Motor Bad Debt Formula: Why It Doesn't Work and How to Adjust It," *Journal of Taxation*, December 1971.

There are a number of other possible ways to approach the question of what treatment of bad debts best measures income. Some have argued that a financial institution's bad debt deductions should be structured so as to make it indifferent, from a tax standpoint, between insuring its loans against risk (e.g. through a mortgage insurance company) and assuming the risk of loss itself. Others have argued that the tax rules should be structured so that the present value of the deductions is no different than that under the specific charge-off method. Still others have argued that the system should correspond to a mark-to-market system, under which taxpayers deduct the decline in the fair market value of their loan portfolio each year.

One difference between a bad debt reserve formula based on experience and one based on a statutory percentage of eligible loans is that the experience method provides larger loss reserves to banks engaging in relatively risky loans (e.g. consumer loans or loans to troubled businesses).

Bad debt reserves as a tax expenditure

The present percentage of taxable income method for savings and loan associations, cooperative banks and mutual savings banks was designed to serve a nontax purpose—encouraging these institutions to specialize in residential mortgage lending and certain other specified types of lending (see footnote 7 above). Thus, the method is available only to institutions which maintain 60 percent or more of their assets in qualifying assets and is phased down to the extent that less than a certain percentage of assets consists of qualifying assets.

The present system, however, does not appear to be well designed as an incentive for residential mortgage lending. Commercial banks and investors other than thrift institutions, which are excluded from the percentage of taxable income method, are given no tax incentive to engage in mortgage lending. Savings and loan associations and mutual savings banks fewer than 60 percent of whose assets qualify as residential mortgages or other types of qualifying assets also have no incentive to increase their mortgage lending, nor do thrift institutions whose qualifying assets exceed 82 percent of total assets (72 percent for mutual savings banks). The 10-point difference in the asset requirement between savings and loan associations and mutual savings banks appears to create an uneven playing field for competition between these institutions. Also, the present system encourages thrift institutions to specialize in mortgage lending (at least up to the 82- and 72-percent levels) which goes against recent trends in financial regulation that have attempted to encourage greater diversification. In past years, there have been recommendations to replace the percentage of taxable income method with some sort of generalized tax incentive for mortgage lending. The thrift institutions argue that the definition of qualifying assets ought to be broadened to include consumer loans and other assets for which the thrift institutions are being given new lending powers, or that the 82- and 72-percent thresholds be reduced.

One consequence of computing the addition to bad debt reserves as a percentage of taxable income is that the marginal tax rate of the typical thrift institution is only 60 percent of the statutory tax rate (i.e., 27.6 percent insted of 46 percent). This gives thrift institutions an incentive to invest in assets that generate taxable income; consequently, their holdings of tax-exempt bonds and their participation in equipment leasing tends to be small, unlike commercial banks.

A second argument for allowing financial institutions to have bad debt reserves in excess of those needed for a proper measurement of income is that federal regulations require that they maintain a certain percentage of their assets in zero or low-yielding assets as reserves or liquidity requirements. Excess bad debt reserves, especially those measured as a percentage of assets, enable financial institutions to build up some of their reserves or liquidity requirements out of pre-tax income, partially compensating them for the burden of the regulations.

Finally, it is argued that recent years have been particularly difficult for thrift institutions and that the national economy has an interest in maintaining the solvency of those institutions. This goal, it is argued, is promoted by generous deductions for additions to bad debt reserves.

B. Interest on Debt Used to Purchase or Carry Tax-Exempt Bonds

Present Law

Overview

Present law disallows the deduction of interest payments on indebtedness incurred to purchase or carry tax-exempt obligations. Under a long-standing judicial and administrative interpretation, bank deposits are not considered to have been accepted for the purpose of acquiring or holding tax-exempt obligations. Thus, a bank may invest deposited funds in tax-exempt obligations while continuing to receive a deduction for the full amount of interest it pays to its depositors. By contrast, individuals and most non-banking corporations which incur debts prior or subsequent to the purchase of tax-exempt obligations, without an independent business or personal reason for doing so, are considered to have incurred the debts for the purpose of acquiring or holding the tax-exempt obligations. These taxpayers are denied an interest deduction to the extent they have used borrowed funds to acquire or hold the tax-exempts.

The law regarding corporate preference items, added in 1982, reduces by 15 percent the amount of the deduction allowed to financial institutions for interest on debt allocable to tax-exempt obligations.

Statutory provisions

Section 163(a) of the Internal Revenue Code allows as a deduction all interest paid or accrued within the taxable year on indebtedness. Banks generally are permitted to deduct interest payments made to customers on amounts maintained as deposits.

Section 265(2) of the Code provides that no deduction shall be allowed for interest incurred or continued to purchase or carry obligations the interest on which is wholly exempt from federal income tax.[1]

Section 291(a)(3) of the Code, added in 1982, reduces by 15 percent the amount allowable as a deduction with respect to certain financial institution preference items. These preference items include interest on indebtedness incurred or continued to purchase or carry tax-exempt obligations, to the extent a deduction would otherwise be allowable for such interest.

The law as generally applied

The Internal Revenue Service and the courts have consistently interpreted the law to disallow an interest deduction only upon a showing that a taxpayer incurred or continued indebtedness for the purpose of acquiring or holding tax-exempt obligations.[2] They have employed various tests to determine whether a taxpayer has the prohibited purpose. In general, when a taxpayer has independent business or personal reasons for incurring or continuing debt, the taxpayer has been allowed an interest deduction regardless of his tax-exempt holdings. When no such independent purpose exists, and when there is a sufficiently direct connection between the indebtedness and the acquisition or holding of tax-exempt obligations, a deduction has been disallowed.[3]

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[1] The provision also disallows a deduction for interest incurred to purchase or carry any certificate to the extent the interest on such certificate is excludable under section 128 (all-savers certificates).

Illinois Terminal Railroad Co. v. *United States,* 179 Ct. Cl. 674, 375 F.2d 1016 (1967), disallowed a deduction for interest on a debt originally incurred for an independent business purpose, when the debt was continued for the purpose of allowing the taxpayer to carry tax-exempt bonds. The court held that the taxpayer lacked "purity of purpose" in continuing its debt.

Similarly, *Wisconsin Cheeseman, Inc.* v. *United States,* 388 F.2d 420 (7th Cir. 1968), denied an interest deduction to a corporation which took out short-term bank loans to meet recurrent seasonal needs for funds, pledging tax-exempt securities as collateral. The court held that the taxpayer could not automatically be denied a deduction because it had incurred indebtedness while holding tax-exempt obligations. However, use of the securities as collateral established a "sufficiently direct relationship" between the loans and the purpose of carrying tax-exempt securities. The court stated further that a deduction should not be allowed if a taxpayer could reasonably have foreseen, at the time of purchasing tax-exempts, that a loan would probably be required to meet ordinary, recurrent economic needs.

In Rev. Proc. 72-18, 1972-1 C.B. 740, the Internal Revenue Service provided guidelines for application of the disallowance provision to individuals, dealers in tax-exempt obligations, business enterprises that are not dealers in tax-exempt obligations, and banks in situations not dealt with in Rev. Proc. 70-20, 1970-2 C.B. 499.[4] The revenue procedure sets forth the general rule that a deduction will be disallowed only where the indebtedness is incurred or continued for the purpose of purchasing or carrying tax-exempt securities. Accordingly, the application of the law requires a determination based on all the facts and circumstances as to the taxpayer's purpose in incurring or continuing each item of indebtedness. This purpose may be established either by direct or circumstantial evidence. Direct evidence of a purpose to purchase tax-exempt obligations also exists where the proceeds of indebtedness are directly traceable to the purchase of tax-exempts. Direct evidence of a purpose to carry tax-exempt obligations also exists when such obligations are used as collateral for indebtedness, as in *Wisconsin Cheeseman* above. In the absence of direct evidence, a deduction will be disallowed only if the totality of facts and circumstances establishes a sufficiently direct relationship between the borrowing and the investment in tax-exempt obligations. A deduction generally will not be disallowed for interest on an indebtedness of a personal nature (*e.g.* residential mortgages) or indebtedness incurred or continued in connection with the active conduct of an active trade or business.

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[2] Legislative history indicates that Congress intended the purposes test to apply. *See, e.g.,* S. Rep. No. 617, 65th Cong., 3d Sess. 6-7 (1918); S. Rep. No. 398, 68th Cong., 1st Sess. 24 (1924); S. Rep. No. 558, 73d Cong., 2d Sess. 24 (1934).

[3] *See generally Phipps* v. *United States,* 188 Ct. Cl. 531, 414 F. 2d 1366 (1969); *Bishop* v. *Comm'r,* 342 F. 2d 757 (6th Cir. 1965), *aff'g* 41 T.C. 154 (1963).

[4] Rev. Proc. 70-20 is discussed in the section concerning the law as applied to banks.

Under Rev. Proc. 72–18, when there is direct evidence of a purpose to purchase or carry tax-exempt obligations, no part of the interest paid or incurred on the indebtedness (or on that portion of the indebtedness directly traceable to the holding of particular tax-exempt obligations) may be deducted. In any other case, an allocable portion of interest will be disallowed. This amount is to be determined by multiplying the total interest on the indebtedness by the ratio of the average amount during the taxable year of the taxpayer's tax-exempt obligations to the average amount of his total assets.

Rev. Proc. 72–18 provides specifically that dealers in tax-exempt obligations are denied an interest deduction when they incur or continue indebtedness for the purpose of holding tax-exempt obligations. When dealers incur or continue indebtedness for the general puprose of carrying on a brokerage business, which includes the purchase of both taxable and tax-exempt obligations, an allocable portion of interest is disallowed.[5] The revenue procedure does not specify under what circumstances, if any, a bank will be treated as a dealer in tax-exempt obligations. This issue may become more significant as banks expand into businesses previously handled by broker-dealers.

The law as applied to banks

Interest on bank deposits

Legislative history indicates that Congress did not intend the disallowance provision to apply to the indebtedness incurred by a bank to its depositors.[6] The Internal Revenue Service took the position as early as 1924 that indebtedness to depositors was not incurred to purchase or carry tax-exempt obligations, within the meaning of the law. In Rev. Rul. 61–22, 1961–2 C.B. 58, the Service stated its position that the provisions of the law "have no application to interest paid on indebtedness represented by deposits in banks engaged in the general banking business since such indebtedness is not considered to be 'indebtedness incurred or continued to purchase or carry obligations * * *' within the meaning of section 265."

The Service has attempted to disallow bank interest deductions in certain cases. Rev. Rul. 67–260, 1967–2 C.B. 132, provided that a deduction will be disallowed when a bank issues certificates of deposit for the specific purpose of acquiring tax-exempt obligations. The ruling concerned a bank which issued certificates of deposit in consideration of, and in exchange for, a State's tax-exempt obligations, the certificates having approximately the same face amount and maturity dates as the State obligations.

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[5] *See Leslie* v. *Comm'r* 418 F.2d 636 (2d Cir. 1969), *cert. den.* 396 U.S. 1007 (1970). The court in *Leslie* held specifically that the exemption of banks under the disallowance provision did not apply to a brokerage business. *See Denman* v. *Slayton*, 282 U.S. 514 (1931).

[6] *See* S. Rep. No. 558, 73d Cong., 2d Sess. 24 (1934); S. Rep. No. 830, 88th Cong., 2d Sess. 80 (1964).

In Rev. Proc. 70-20, 1970-2 C.B. 499, the Service issued guidelines for application of the disallowance provision to banks holding tax-exempt State and local obligations. The revenue procedure provides that a deduction will not be disallowed for interest paid or accrued by banks on indebtedness which they incur in the ordinary course of their day-to-day business, unless there are circumstances demonstrating a direct connection between the borrowing and the tax-exempt investment. The Service will ordinarily infer that a direct connection does not exist in cases involving various forms of short-term indebtedness,[7] including deposits (including interbank deposits and certificates of deposit); short-term Eurodollar deposits and borrowings; Federal funds transactions (and similar interbank borrowing to meet State reserve requirements, and other day-to-day and short-term interbank borrowings); repurchase agreements (not involving tax-exempt securities); and borrowings directly from the Federal Reserve to meet reserve requirements. However, even though indebtedness falls within one of the above categories, unusual facts and circumstances outside of the normal course of business may demonstrate a direct connection between the borrowing and the investment in tax-exempt securities. In these cases, a deduction will be disallowed. The Service will not infer a direct connection merely because tax-exempt obligations were held by the bank at the time of its incurring indebtedness in the course of its day-to-day business.

Under Rev. Proc. 70-20, application of the disallowance provision to long-term capital notes is to be resolved in the light of all the facts and circumstances surrounding the issuance of the notes. A deduction will not be disallowed for interest on indebtedness created by the issuance of capital notes for the purpose of increasing capital to a level consistent with generally accepted banking practice. Types of borrowings not specifically dealt with by the revenue procedure are to be decided on a facts and circumstances basis.[8]

Rev. Proc. 78-34, 1978-2 C.B. 535, provided that the Service will allow a deduction for interest paid by commercial banks on borrowings of Treasury tax and loan funds when those borrowings are secured by pledges of tax-exempt obligations. The revenue procedure involved transactions in which a depository bank issues interest-bearing notes to the Treasury representing funds withdrawn from the bank's tax and loan account, the notes to be payable upon demand. The Service took the position that this type of borrowing is in the nature of a demand deposit.[9]

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[7] For purposes of the revenue procedure, "short-term bank indebtedness" means indebtedness for a term not to exceed three years. A deposit for a term exceeding three years will be treated as short-term when there is no restriction on withdrawal, other than loss of interest.

[8] Rev. Proc. 72-18, discussed above, is applicable to banks in situations not dealt with in Rev. Proc. 70-20.

[9] Rev. Proc. 80-55, 1980-2 C.B. 849, would have disallowed a deduction for interest paid by commercial banks on certain time deposits made by a State and secured by pledges of tax-exempt obligations. The revenue procedure concerned banks that participate in a State program that requires the banks to bid for State funds and negotiate the rate of interest, and requires the State to leave such deposits for a specified period of time. The Service took the position that direct evidence of a purpose to purchase or carry tax-exempt obligations exists in such transactions under Rev. Proc. 72-18.

Continued

In addition to the foregoing administrative rulings and procedures, two recent court decisions concerned the application of the disallowance provision to financial institutions. In *Investors Diversified Services, Inc.* v. *United States,* 573 F. 2d 843 (Ct. Cl. 1978), the court found that the use of tax-exempt securities as collateral for face-amount certificates[10] was not sufficient evidence of a purpose to purchase or carry tax-exempt obligations. Summarizing the existing law, the court stated that "where the issue is disputed there should always be an inquiry, more-or-less particularized, into the connection and relationship between the tax-exempts and the indebtedness so as to discover whether in fact the taxpayer used borrowed funds for the primary purpose of purchasing or carrying those securities." Noting the many similarities between banks and face-amount certificate companies,[11] the court held that the rationale for the "bank exception" to the disallowance provision was equally applicable to these companies. The court cited three further grounds for holding the disallowance provision inapplicable: (1) that the sale of certificates (*i.e.* borrowing) was wholly separate from and independent of the company's investment process, including the acquisition and maintenance of exempt securities; (2) that the essential nature of the company's business was the borrowing of money which had to be invested in order to pay off the certificate holders; and (3) that the company could not reduce its borrowings by disposing of its tax-exempts, since only the certificate holders had the power to terminate each certificate.

Finally, in *New Mexico Bancorporation* v. *Commissioner,* 74 T.C. 1342 (1980), the Tax Court permitted a bank a deduction for interest paid on repurchase agreements which were secured by tax-exempt State and municipal obligations. The court concluded that the repurchase agreements were similar to other types of bank deposits, and were not the type of loans or indebtedness intended to be covered by the disallowance provision. Furthermore, the bank's purpose for offering repurchase agreements was independent of the holding of tax-exempt obligations.

Recent legislative developments

The Tax Equity and Fiscal Responsibility Act of 1982 added a provision which reduces by 15 percent the amount allowable as a deduction with respect to any financial institution preference item. The Act defined financial institution preference items to include

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Rev. Proc. 80-55 was revoked by Rev. Proc. 81-16, 1981-1 C.B. 688. However, Rev. Proc. 81-16 states that the disallowance provision will continue to apply to interest paid on deposits that are incurred outside of the ordinary course of the banking business, or in circumstances demonstrating a direct connection between the borrowing and the tax-exempt obligations.

[10] Face-amount certificates are certificates under which the issuer agrees to pay to the holder, on a stated maturity date, at least the face amount of the certificate, including some increment over the holder's payments. Present law (sec. 265 (2)) provides specifically that interest paid on face-amount certificates by a registered face-amount certificate company shall not be considered as interest incurred or continued to purchase or carry tax-exempt obligations, to the extent that the average amount of tax-exempt obligations held by such institution during the taxable year does not exceed 15 percent of its average total assets. The *Investors Diversified Services* case involved a face-amount certificate company whose tax-exempt holdings exceeded 15 percent of its total assets.

[11] The court noted that both banks and face-amount certificate companies were subject to State banking laws; both competed for the savings of the general public; and both had to invest money obtained from depositors/purchasers to secure payment of an agreed rate of interest to them.

interest on indebtedness incurred or continued by financial institutions[12] to purchase or carry tax-exempt obligations acquired after December 31, 1982, to the extent that a deduction would otherwise be allowable for such interest. Unless the taxpayer (under regulations to be prescribed by the Treasury) establishes otherwise, the 15 percent reduction will apply to an allocable portion of the taxpayer's aggregate interest deduction, to be determined by multiplying the aggregate deduction by the ratio of the taxpayer's average adjusted basis of tax-exempt obligations to the average adjusted basis of the taxpayer's total assets. For example, a bank which has invested 25 percent of its assets in tax-exempts will be denied a deduction for $3,750 of each $100,000 of interest paid to its depositors during the taxable year (15 percent × $25,000 interest allocable to debt used to acquire or hold tax-exempts).

Issues

Overview

The allowance of an interest deduction to banks which acquire or hold tax-exempt obligations raises a number of legal and policy issues. These include (1) administrative problems, including the tracing of borrowed funds and the allocation of funds among different purposes of the taxpayer; (2) a concern for tax equity, since banks are generally allowed to deduct interest on debt used to finance the acquisition or holding of tax-exempt obligations, while most other taxpayers are prohibited from doing so; and (3) the probable effect of any modification of the existing rule on the market for tax-exempt State and municipal bonds.

Administrative problems

The disallowance provision generally

The basic policy of the disallowance provision is to prevent a taxpayer from receiving tax-exempt income and paying tax-deductible interest on the same or equivalent funds. Thus, in a simple case, a taxpayer who borrows $10,000, which he then immediately invests in tax-exempt obligations, is denied a deduction for interest paid to the lender on the $10,000. This prevents a result under which the taxpayer, by receiving the benefits of both tax-exempt income and the interest deduction, would profit (and thereby reduce tax revenues) merely by serving as a pass-through for the funds. Effectively, the law denies the taxpayer the benefits of tax-exempt income to the extent he has financed the acquisition of tax-exempts with the proceeds of indebtedness.[13]

As the taxpayer's finances become more complex, the administration of the disallowance provision becomes progressively more complicated. Because money is essentially fungible—that is, because one $10,000 is the same as any other $10,000—it is difficult to determine whether a taxpayer is financing the acquisition or holding of particular tax-exempt obligations with the proceeds of any particular indebtedness. It may be even more difficult to determine whether the taxpayer has the actual purpose of doing so. This is particularly true in the case of a corporation (or a wealthy individual) which constantly incurs debt for a variety of purposes and which also, in separate transactions, acquires and holds tax-exempts.

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[12] The provision is applicable to mutual savings banks, domestic building and loan associations, and cooperative banks, as well as to commercial banks.

[13] The extent to which the taxpayer actually loses the advantage of tax-exempt income depends upon the prevailing interest rates for taxable and tax-exempt obligations.

Application to banks

The fungibility problem is particularly acute with regard to banks, whose major business consists of the lending and borrowing of interchangeable sums of money, including (to varying degrees) the acquisition and holding of tax-exempt obligations. Even the purposes test, when applied to banks, may result in conflicting conclusions. A bank may argue that, in accepting deposits, it is simply carrying on its general business as a bank[14]—in a sense, that it has an independent business purpose for incurring debt to its depositors. Accordingly, the bank should be allowed an interest deduction under the general principles applicable to all taxpayers. (Alternatively, the bank may argue that the acceptance of deposits does not constitute borrowing, at all.[15]) It may also be argued, however, that one of the major purposes of a bank's general business (as demonstrated by bank practice) is the acquisition and holding of tax-exempt obligations. Thus an allocable portion of deposits accepted in the general course of business should be considered to have been accepted for the purpose of investing in tax-exempts, and the deduction for that portion should be disallowed. This would be equivalent to the treatment accorded under present law to dealers in tax-exempt obligations (other than banks) who borrow money for the purpose of conducting a general brokerage business, including the acquisition and holding of tax-exempts.[16]

Use of a formula for allocation of a bank's deposits between taxable and tax-exempt assets also presents special difficulties. The formulas applied to non-banking taxpayers, which generally rely upon the ratio of tax-exempt obligations to a taxpayer's total assets, may not be adequate to reflect the reality of the banking business. In cases where the interest rate on tax-exempt bonds is less than the interest rate paid by the bank, application of these formulas could result in a loss of deductions in excess of the benefits received from tax-exempt income.

Tax equity

Banks vs. taxpayers generally

Aside from revenue considerations, the strongest argument against present law is that it distinguishes in its application between banks and other taxpayers. By using deposited funds to purchase and carry tax-exempts, banks are able to enjoy the benefits of receiving tax-exempt investment income and paying tax-deductible interest on the same or equivalent funds. This is precisely the double benefit which is denied to other taxpayers. The volume of tax-exempt obligations held by banks indicates that banks have made extensive use of deposited funds to acquire and hold tax-exempts.

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[14] *See Investors Diversified Services, Inc.* v. *United States*, 573 F.2d 843, 852–53. (Ct. Cl. 1978.)

[15] Banks may argue that deposits are distinguished from most other forms of debt, since they are (1) for an unspecified period, and (2) terminable at the will of the depositor, but not of the bank. *See Investors Diversified Services, Inc.* v. *United States*, 573 F.2d 843, 853. (Ct. Cl. 1978.) This argument is obviously less applicable for time deposits.

[16] *See* Rev. Proc. 72-18, 1972-1 C.B. 740; *Leslie* v. Comm'r, 413 F.2d 636 (2d Cir. 1969), *cert. den.* 396 U.S. 1007 (1970).

The ability to deduct interest on debt used to purchase tax-exempt securities makes it possible for a bank to eliminate its taxable income by investing a relatively small percentage of its assets in tax-exempt securities. For example, a bank that earns an average return of 8 percent on its taxable assets and pays an average of 8 percent on deposits will pay no tax if it invests 20 percent of its assets in tax-exempt securities.

A particular problem under present law is the use of tax-exempt obligations as collateral for deposits or other short-term bank borrowing. By using tax-exempts as collateral, a bank receives tax benefits when it is really the depositor (who may be tax-exempt or have a low marginal tax rate) who is lending to the issuing government. State and municipal deposits in particular are frequently collateralized with tax-exempt obligations, sometimes of the same State or municipality.[17] In these latter cases, the Federal government subsidizes a transaction in which there is no net borrowing by the State or local government.

Limitations on bank exemption

The history of the disallowance provisions indicates two approaches to limiting the exemption of banks under the disallowance provision. First, the Internal Revenue Service has, on at least two occasions, acted to curb what it perceived as particular abuses of the exemption. Thus, in Rev. Proc. 76-260 *supra,* the Service disallowed a deduction for interest on certificates of deposit which a bank had issued in exchange for tax-exempt State obligations, the certificates having approximately the same face amount and maturity dates as the State obligations. Rev. Proc. 80-55, 1980-2 C.B. 849, would further have disallowed a deduction for interest paid by commercial banks on certain time deposits made by a State and secured by pledges of tax-exempt obligations; however this revenue procedure was subsequently withdrawn.[18]

The difficulty with this approach is that it is necessarily piecemeal, reacting to specific perceived abuses as they occur. Moreover, the approach still applies a different, more favorable standard to banks than to other taxpayers. While taxpayers generally must establish an independent business or personal purpose for incurring debt, banks will be subject to disallowance of interest only when *"unusual facts and circumstances outside of the normal course of business* . . . demonstrate a direct connection between the borrowing and the investment in tax-exempt securities." Rev. Proc. 70-20, 1970-2 C.B. 499, 500 (emphasis supplied). The law thus creates a presumption that debts incurred in the normal course of the banking business are exempt from the disallowance provision. The great majority of a bank's debts will, therefore, qualify for the exemption.

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[17] State and local law generally requires that State and municipal deposits be collaterialized with obligations of specified governmental bodies. These may include taxable or tax-exempt obligations.

[18] The withdrawal of Rev. Proc. 80-55 followed vigorous protests by banks and by various States and municipalities, which argued, *inter alia,* that the revenue procedure would cause serious damage to the market for tax-exempt bonds. This issue is discussed below.

Congress took a second approach in 1982 when it characterized the deductibility of interest on debt used to acquire or hold tax-exempt obligations as a financial institution preference item, and reduced the otherwise allowable deduction for this type of interest by 15 percent. This reduction was accompanied by equivalent cutbacks in various other items characterized as corporate tax preferences.[19] By its own terms, however, the 1982 Act reduced, rather than eliminated, the benefits enjoyed by banks with regard to the interest deduction. To the extent that banks are treated differently than other taxpayers, they continue to be treated differently with respect to 85 percent of the interest at issue. The flat reduction approach also raises potential problems of enforcement and allocation,[20] particularly with regard to affiliated and consolidated corporations. Finally, a flat reduction does not take into account the particular situations of various banks, or their reason for acquiring or holding tax-exempts.

Each of the approaches above suggests possible further changes in the application to banks of the disallowance provision. Congress could act, or direct the Internal Revenue Service to act, to curb perceived areas of abuse by financial institutions and issuing jurisdictions, including (but not limited to) certain kinds of deposits collaterized with tax-exempt obligations. Congress could also impose further numerical or percentage limits on the overall amount of the deductions at issue. Each of these approaches would involve the problems suggested by the discussion above. Alternatively, Congress could act to eliminate the entire deduction for interest paid by banks on debt used to acquire or hold tax-exempts.

State and municipal finance

Tax-exempt bonds are a major source of financing for State and municipal governments. In effect, denying the interest deduction in proportion to a taxpayer's holdings of tax-exempt obligations involves taxing a fraction of the otherwise tax-exempt interest (under some formulas, more than 100 percent of the interest). This reduces the attractiveness of the bonds to potential holders. Legislative history indicates a Congressional concern that, if banks were denied an interest deduction in proportion to their tax-exempt holdings, the banks would eliminate or substantially reduce their investments in tax-exempt bonds. The Senate Finance Committee in 1934, rejecting a proposed change in the rule, expressed the opinion "that the change made by the House bill will seriously interfere with the marketing of government securities, which are bought for the most part by banks and financial institutions, and also presents grave administrative difficulties." [21]

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[19] The law also characterized excess bad debt reserves as a financial institution preference item.

[20] The law provides (unless the taxpayer establishes otherwise) for disallowance of 15 per cent of that portion of deductible interest which is equivalent to the proportion of tax-exempt obligations acquired after 1982 in the taxpayer's total assets. This is essentially the same formula used to allocate interest for taxpayers generally (with the exception that 100 percent of allocated interest in the case of a general taxpayer will be disallowed). Because the law is effective only for taxable years beginning on or after January 1, 1983, there is as yet no available data regarding compliance or enforcement.

In 1980, when the Internal Revenue Service issued Rev. Proc. 80-55 *supra*, banks, and various State and local governments, protested that the disallowance of deductions on the deposits in question would depress the market for tax-exempt bonds, making it more difficult for States and municipalities to raise needed funds. Additionally, they argued that banks would refuse to accept State and municipal deposits, which generally must be secured by specified taxable or tax-exempt obligations. (It was also argued that the revenue procedure was inconsistent with previous interpretations of the disallowance provision.)

The Service revoked Rev. Proc. 80-55 in April 1981. In a statement accompanying the revocation, the Treasury and the IRS concluded that the overall effect of the revenue procedure on the municipal bond market, the banking system and the fiscal health of State and local governments would have been slight.[22] This referred, however, only to the effect of the revenue procedure itself, rather than to the presumably broader effect of disallowing interest deductions on all deposits in proportion to a bank's tax-exempt holdings.

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[21] S. Rep. No 558, 73d Cong., 2d Sess. 24 (1934).

[22] Revenue Procedure 80-55: Hearing Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means, 97th Cong., 1st Sess. 4 (1981) (statement of John E. Chapoton, Assistant Secretary (Tax Policy), Department of the Treasury, and Roscoe L. Egger, Jr., Commissioner of Internal Revenue).

C. Foreign Income

Present Law

Foreign tax credit

The United States taxes U.S. citizens and residents and U.S. corporations on their worldwide income. The United States allows U.S. taxpayers to offset the U.S. tax on their foreign income by the income taxes paid to a foreign country ("foreign tax credit").

In addition, a U.S. corporation that owns 10 percent or more of the stock of a foreign corporation may credit foreign income taxes paid or deemed paid by that foreign corporation on earnings that are distributed as dividends.

A credit is available only for foreign taxes that are income taxes under U.S. concepts (sec. 901) and certain taxes paid to a foreign government in lieu of an income tax otherwise imposed by that foreign government (sec. 903). A foreign tax is an income tax if it is designed to reach realized net income. Certain taxes imposed on gross payments of interest and other passive type income are creditable. However, gross withholding taxes imposed on gross recipts of U.S. taxpayers engaged in trade or business in a foreign country have been held not creditable (Rev. Rul. 78-233, 1978-1 C.B. 236).

A fundamental premise of the foreign tax credit is that it should not offset the U.S. tax on U.S. source income. Accordingly, the Code contains a limitation to ensure that the credit offsets the U.S. tax on only the taxpayer's foreign income. The limitation is determined by using a ratio of foreign source taxable income to total worldwide taxable income.[1] The resulting fraction is multiplied by the total pre-credit U.S. tax to establish the amount of U.S. taxes that, absent a foreign tax credit, would be paid on the foreign income and, thus, the upper limit on the foreign tax credit. Deductions apportioned to foreign source gross income reduce the foreign tax credit limitation, while deductions apportioned to U.S. source income do not.

The United States has entered into a number of bilateral income tax treaties that reduce or eliminate source country flat-rate withholding taxes on passive income, including interest. The U.S. position is that the rate on interest should be zero. A number of treaties have a zero rate only for interest paid to banks.

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[1] Historically, the foreign tax credit limitation has been based upon either the taxpayer's worldwide foreign income or his foreign income from each separate country, or both. These are known as the overall limitation and the per-country limitation, respectively. Under the per-country limitation, taxes paid to any foreign country could be used against only the pre-credit U.S. tax on income from sources within that country. Today, some foreign countries use a per-country limitation, while others use a separate limitation for every item of income.

U.S. taxation of foreign corporations and their U.S. shareholders

Foreign corporations generally are taxed by the United States only on their U.S. source income and on foreign source income that is effectively connected with a trade or business conducted in the United States. Accordingly, the foreign source income of a foreign corporation is subject to U.S. income tax only when it is actually remitted to the U.S. shareholders as a dividend. However, under the subpart F provisions of the Code,[2] income from certain tax haven type activities conducted by corporations controlled by U.S. shareholders is deemed to be distributed to the U.S. shareholders and currently taxed to them (subject to a foreign tax credit). The categories of income taxed include foreign personal holding company income which in turn includes interest income. Also, earnings of controlled foreign corporations are generally taxed currently to U.S. shareholders if they are invested in certain U.S. property.

Rules of particular significance for U.S. banks

In general, banks are subject to the same tax rules on their income from international transactions as other U.S. taxpayers. Some of these rules are of particular significance to banks and are described below.

Source of income

Foreign source taxable income increases a taxpayer's foreign tax credit limitation. Foreign source income may thus increase the amount of foreign taxes a taxpayer may credit and decrease the taxpayer's U.S. tax liability. For this reason, taxpayers may prefer foreign source income to U.S. source income.

Interest income has its source in a country when the obligor is a governmental entity, a corporation, or another entity resident in that country. Thus, interest on a loan to a foreign entity is foreign income regardless of where the loan proceeds are used.[3] However, a proportionate amount of the interest paid by a foreign corporation is treated as U.S. source if 50 percent or more of that corporation's gross income is effectively connected with a U.S. trade or business, while all interest paid by a U.S. corporation is foreign source if the corporation has over 80 percent of its gross income from foreign sources over the past three years.

Under these rules, if a bank lends to a foreign corporation (such as a foreign bank) that invests in the United States, or to a foreign subsidiary of a U.S. corporation that invests abroad, the bank will generally earn foreign source interest income.

As a general rule, the source of income from leasing a vessel or aircraft is where the vessel or aircraft is used. Thus, most of the income from vessels or aircraft used in international commerce would be foreign source, and related deductions would be allocable or apportionable to foreign sources and would reduce the available foreign tax credit limitation. However, in 1971, Congress enacted a special elective rule allowing U.S. lessors to treat income and deductions from leases of certain ships and aircraft as U.S. source. In adding this elective rule, Congress took notice that "One of the principal means available to finance the purchase of ships or aircraft is a leasing arrangement under which a financial institution purchases the ship or aircraft and then leases it to the air carrier or ship operator . . . ." S. Rep. No. 92-437, 92d Cong., 1st Sess. 78. "Typically, in a leasing transaction of this type, the lease produces a tax loss during its early years to the lessor (primarily as a result of the depreciation deduction)." *Id.* Congress created the election to treat these losses as reducing U.S. income because "The characterization of the loss as foreign source in combination with the limitation on the foreign tax credit can have the effect of causing the financial institution to lose a foreign tax credit to which it would otherwise be entitled for foreign taxes paid with respect to its foreign banking or other financial operations." *Id.* Although the primary intent of this elective rule was to provide air carriers and ship operators with the financing needed to acquire new equipment, this rule incidentally benefitted banks.

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[2] Similar rules would apply to tax U.S. shareholders of foreign personal holding companies.

[3] Banks may be able to source other income in foreign countries by locating operations or transferring title there. Only the easy transferrability of money may distinguish banks from other taxpayers in this respect.

In 1980, Congress made this elective rule mandatory (Public Law 96-605, Code sec. 861(e)).

The source of income from foreign currency trading is generally the country where title to the currency passes to the buyer. This rule may allow banks to generate foreign source income from profitable investments and U.S. losses from unprofitable investments.

Apportionment of interest expense

The apportionment of deductions between U.S. and foreign source gross income has a significant impact on the foreign tax credit limitation. Because banks, by the nature of their business, borrow large sums of money, the rules governing apportionment of interest expenses to U.S. and foreign sources are of particular importance to banks.

Method.—The Treasury Regulations governing allocation and apportionment of interest expense are generally based on the approach that money is fungible and that interest expense is attributable to all activities and property of the payor regardless of any specific purpose for incurring an obligation on which interest in paid (Treas. Reg. sec. 1.861-8(e)(2)(i)). The regulations do not provide for tracing of interest expense on borrowed funds to the investments made with those funds. To the extent that banks obtain funds for loans to U.S. borrowers more cheaply than they obtain funds for loans to foreign borrowers, the Regulations provide more foreign source taxable income than a tracing approach and tend to increase the banks' foreign tax credit limitation. This may reduce the banks' U.S. tax liability on foreign source income.

In general, taxpayers may allocate interest deductions to specific property only in the case of certain nonrecourse debt (Treas. Reg. sec. 1.861-8(e)(iv)). Taxpayers may elect, on an annual basis, to apportion interest deductions that are not allocable to specific property by either of two methods, the asset method or the gross income method.[4] Under the asset method a taxpayer may apportion its interest deductions between foreign and domestic sources by comparing assets generating foreign gross income to assets generation all gross income. The debt obligation of a foreign entity will ordinarily be a foreign asset. Under the gross income method, expenses are apportioned to offset foreign source income by comparing foreign source gross income to worldwide gross income.

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[4] Foreign corporations engaged in trade or business in the United States are subject to a different set of rules, discussed below, for determining interest deductions for U.S. tax purposes.

Interest paid to carry tax-exempt bonds.—As described above, a bank may invest deposited funds in tax exempt obligations while continuing to deduct the full amount of interest it pays to depositors. However, the tax exempt obligations are domestic assets for purposes of applying the asset method of allocating interest deductions between United States and Foreign sources.

Elections.—Under the asset method the taxpayer has additional flexibility to apportion interest deductions. The taxpayer may generally choose to value assets on the basis of book value or on the basis of fair market value. In addition, taxpayers using the asset method may apportion interest on certain debt incurred before January 1, 1977 by certain other methods.

Separate limitation for interest income

The foreign tax credit limitation is computed separately for certain interest income (sec. 904(d)). Interest "derived in the conduct by the taxpayer of a banking, financing, or similar business . . ." is excluded from that separate limitation. (Code sec. 904(d)(2)(B)).

The absence of a separate limitation for interest derived in the banking business could allow credits for foreign taxes on other foreign income, such as foreign fee income, to reduce U.S. tax on interest income. Likewise, foreign income taxes imposed on interest income can reduce U.S. tax on other classes of foreign income.

Foreign subsidiaries of U.S. banks

Interest income (as well as dividends and certain gains on the sale of stock or securities) of a foreign banking subsidiary of a U.S. bank is exempt from subpart F, and thus, is not taxed to the U.S. shareholder if it is derived in the conduct of a banking or other financial business and is received from an unrelated party (Code sec. 954(c)(3)(B)).[5] The securities producing that income must be "acquired as an ordinary and necessary incident" to the conduct of a banking business (Treas. Reg. sec. 1.954-2(d)(2)(iii). For this purpose, "securities" include any debt obligation or right to purchase any debt obligation. In general, however, certain second-tier subsidiaries of national or State banks which are members of the Federal Reserve System need not meet the "incidental" test (Treas. Reg. sec. 1.954-2(d)(2)(iv)).

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[5] The Internal Revenue Code contains two sets of rules aimed at preventing the use of corporations to avoid taxation on passive income at the level of the ultimate investor, the shareholder. Neither set of rules generally applies to foreign subsidiaries of U.S. banks engaged in a banking business. One such set of rules, the personal holding company rules, does not apply to U.S. banks or, in general, to foreign corporations that derive 60 percent or more of their ordinary gross income "directly from the active and regular conduct of a lending or finance business" (sec. 542(c)). The other set of rules, the foreign personal holding company rules, does not generally apply to "a corporation organized and doing business under the banking and credit laws of a foreign country if it is established . . . to the satifaction of the Secretary that such corporation is not formed or availed of for the purpose of evading or avoiding United States income taxes which would otherwise be imposed upon its shareholders" (sec. 552(b)(2)).

There is another special rule in the subpart F provisions for banks. Although most U.S. shareholders are subject to some current taxation if income from certain transactions with related parties amounts to 10 percent of the gross income of a controlled foreign corporation, subsidiaries of U.S. banks may generally receive up to 30 percent of their gross income from related parties in the banking business without subjecting the U.S. parent to current taxation under subpart F (Code sec. 954(c)(4)(B), Treas. Reg. sec. 1.954–2(e)(2)).

Interest deductions of foreign banks

Under Treasury Regulations, for purposes of computing their U.S. taxable income, foreign corporations are subject to rules for allocation of interest deductions that are different from the "fungibility" rules governing U.S. corporations. Foreign corporations engaged in U.S. trade or business may elect a "branch book/dollar pool" method, which considers primarily the interest the branch paid and secondarily dollar borrowings of the foreign corporation, or a "separate currency pools" method, which considers the interest the corporation paid on a currency-by-currency basis (Treas. Reg. sec. 1.882-5). Under these rules, low-cost home country deposits need not reduce U.S. interest deductions. In addition, borrowings in a strong currency that bear a low nominal rate of interest to compensate for expected appreciation in value of principal need not reduce U.S. interest deductions.

Miscellaneous rules

A number of tax rules governing the customers of banks incidentally provide special treatment for banks.

Tax law encourages foreign persons to make deposits in U.S. banks. Foreign persons are generally not subject to U.S. income taxation on deposits in U.S. banks unless the income from those deposits is effectively connected with a trade or business in the United States. Nonresident aliens are generally not subject to estate or gift taxation on gratuitous transfers of such deposits. Banks have only a minor burden in policing the identity of persons who claim foreign status. There is no requirement that payors of interest to persons claiming foreign status report such payments to the Internal Revenue Service.

Persons collecting foreign items (such as interest or dividends paid by foreign corporations) for U.S. persons need not report the collection of such foreign items unless they amount to $600 or more (Treas. Reg. sec. 1.6014–4).

In general, under the subpart F provisions of the Code, a foreign corporation controlled by U.S. shareholders subjects those shareholders to current U.S. tax when it invests its retained earnings in United States property, such as stock or debt of domestic issuers. A special statutory provision exempts from this rule "deposits with persons carrying on the banking business" (Code sec. 956(2)(A)).

Issues

Measure of foreign source income

The present method of computing foreign source income for purposes of the foreign tax credit limitation may result in higher foreign source income than would seem correct. If so, too much foreign tax could be credited. Additional foreign tax credits could reduce U.S. tax and might permit banks to reduce U.S. tax on what should be considered U.S. source income. On the other hand, the present method may result in a correct computation of foreign source income. The key elements in this calculation are the source of income rules and the alloction of deduction rules.

Source of income

Proponents of the current rule that the source of interest income is the residence of the payor argue that this rule allows U.S. taxpayers to treat as foreign source income the income that foreign governments are likely to tax. This result, they argue, is consistent with the policy of the credit to mitigate double taxation.

Opponents of the current rule argue that it gives taxpayers the flexibility to lend to a foreign member of a related group and thus to increase the foreign tax credit limitation. They point out that lenders may thus generate foreign source income that will be subject to no foreign tax.

Proponents of the current rules treating leasing of U.S. ships and aircraft as yielding U.S. source income and deductions argue that this treatment is appropriate because foreign countries are unlikely to tax such leasing income. Therefore, categorization as foreign source is unnecessary. Opponents of this rule argue that the special rule tends artificially to reduce U.S. source income and to benefit lessors, and that the general rule reducing foreign source income would be as appropriate in this context as elsewhere.

Proponents of the current rule that the source of foreign currency trading income is the country where title passes note that this rule is a generally accepted source rule. They argue that any other rule would be unworkable or arbitrary.

Opponents of the title passage rule argue that it allows banks selling currency to increase foreign source income and to decrease U.S. source income.

Allocation rules

Proponents of current law allocation of interest expenses argue that money is fungible and that interest expense is attributable to all the activities and property of a business regardless of any specific purpose for incurring an obligation on which interest is paid. Fungibility, they say, recognizes that all activities and property require funds and that management has a great deal of flexibility as to the source and use of funds. They contend that when money is borrowed for a specific purpose, such borrowing will generally free other funds for other purposes and that it is reasonable to attribute the cost of borrowing to such other purposes.

Opponents of the current fungibility rule argue that tracing would result in a more accurate calculation of foreign source income. They argue that fungibility artificially increases the foreign tax credit limitation and thus may reduce U.S. taxes. For example, assume that a bank (1) borrows $1,000 from a U.S. depositor at 5 percent and invests that $1,000 in a loan to a U.S. borrower yielding 9 percent, and (2) borrows $9,000 from a foreign depositor at 10 percent and invests that $9,000 in a loan to a foreign borrower yielding 11 percent. A tracing method would treat $40 as U.S. source income and $90 as foreign source income. The asset method apportions the total $950 of interest paid on the basis of assets. U.S. assets ($1,000) are 10 percent of total assets, so $95 (10 percent of interest expense) is deducted from U.S. source income. This results in a U.S. loss of $5 ($90 interest received less $95). Foreign source income is $135 ($990 of interest received less $855 (90 percent x $950)). Opponents of fungibility say that both these loans are profitable. They also note that foreign banks doing business in the United States are not subject to the fungibility rules. They argue that when interest rates in this country vary from interest rates abroad, these different interest rates reflect different costs of banking in this country and abroad. They note that foreign banks (1) factor in interest rate differentials and (2) disregard any low-cost home country deposits in calculating U.S. income. If fungibility is inappropriate for these banks, opponents argue, it is also inappropriate for U.S. banks.

Proponents, however, argue that tracing of interest expense to specific assets would cause administrative difficulties. They also argue that tracing could cause compensatory taxpayer behavior, such as seeking to match low-cost funds with foreign assets. Such behavior could include requirements that U.S. borrowers (or related parties) establish low-interest-rate deposits overseas.

Opponents of current law argue that even if fungibility is the correct approach, there should be one method of calculating interest deductions under that approach to yield the correct result. Thus, they say, there should be no elections among asset method, book or fair market value, and gross income method.

Proponents of the current elections argue that these elections are necessary to measure properly income of differently situated businesses, some of which have high foreign assets in relation to foreign gross income, and some of which have low foreign assets in relation to foreign gross income.

Interest paid to carry tax-exempt bonds

Proponents of the current rule treating tax-exempt obligations like any other U.S. asset for the purpose of apportioning interest expense argue that this rule reflects the true economic nature of the transactions because interest paid to carry tax-exempt bonds relates to U.S. assets. They also argue that this rule is consistent with the policy of permitting the deduction of the interest which is to encourage banks to hold tax-exempt State and municipal obligations. Removing these obligations from the allocation would be inconsistent with this policy.

Opponents of the current rule argue that if banks should not trace interest deductions to tax-exempt interest income in determining the *amount* of income, banks should not trace interest deductions to tax-exempt income in determining the *source* of income. They argue that it is inappropriate to derive a second tax benefit (higher foreign source income) from ownership of a tax-exempt asset.

Gross withholding taxes

Proponents of the creditability of gross withholding taxes on passive income argue that such taxes are income taxes. They note that such taxes are a standard international device, that the United States has such taxes, that the United States labels its taxes income taxes and that other countries credit these U.S. taxes. Even if these taxes are not income taxes, proponents of the current rule argue that such taxes are comparable to income taxes and are thus creditable as taxes in lieu of income taxes. They note that the rates of such taxes are not unlike marginal income tax rates in the United States. They note that a taxpayer who invests his own capital is subject to net income tax rates beyond the 25–30 percent range in the United States and in many other countries.

Opponents of creditability argue that a gross withholding tax on persons in the active business of lending money is neither an income tax nor comparable to a net income tax. They note that lending margins of bankers rarely attain the rates of gross withholding taxes, which can reach 15 or 25 percent of gross interest. They argue that if the lender is bearing the tax, the tax is not designed to reach net income but rather to exceed net income and is thus not creditable. They say that if the borrower, not the lender, is bearing most or all of these taxes, then they should not be creditable against the lender's U.S. taxes. They argue that current law may allow foreign tax credits for high taxes to eliminate the U.S. tax on other, low-taxed, foreign source income. Opponents argue that these credits, if allowable at all, should not apply against taxes on other foreign source income.

Proponents of creditability argue that it may be in the interest of the United States to credit certain taxes, even though they may be relatively high, imposed by friendly countries. Creditability may encourage private investment in these friendly countries and may indirectly help create markets for U.S. goods and jobs for U.S. workers.

Some argue that even if gross withholding taxes generally should be creditable, such taxes imposed by a foreign government on a loan to a government-owned corporation or a quasi-governmental entity should not be creditable or should be separately limited. They argue that such taxes constitute a rebate of interest charges.

Proponents of creditability argue that the identity of the borrower should not affect the creditability of taxes. They note that the United States taxes the interest income it pays.

Those concerned about the creditability of gross withholding taxes also object to the absence of a separate foreign tax credit limitation for banks' interest income. They argue that current law allows only banks to offset U.S. tax on low-taxed foreign source fee income or trading income with credits from high-taxed foreign source interest income (or vice versa).

Proponents of the current rule exempting banks from the separate limitation for interest income argue that interest in the hands of banks is active business income, and should not be treated differently from other business active income.

Deferral

Proponents of the deferral of U.S. taxation on the earnings of controlled foreign banking subsidiaries argue that interest income, although passive in the hands of an investor, is active income in the hands of a financial intermediary.

Apparently, the reported return on assets on U.S. banks' foreign subsidiaries is higher than that of both the total international operations of large U.S. banks and the banks' consolidated (worldwide) operations. Board of Governors of the Federal Reserve System Staff Study, Foreign Subsidiaries of U.S. Banking Organizations 6 (1982).

Opponents of deferral argue that these high reported returns may indicate that banks can choose to do highly profitable business offshore. They argue that interest income is passive income even in the hands of a financial intermediary. They argue that it is easy to choose to earn interest income or currency trading income in a controlled subsidiary and thus to defer U.S. tax.

Proponents of deferral argue that reported return on assets does not necessarily reflect economic profits. They note that ending deferral would create administrative problems.

Some may argue that even if deferral is proper as a general rule for foreign subsidiaries of U.S. banks, the current rule allowing receipt of up to 30 percent of gross income from related parties without incurring subpart F income is too lenient. Such a rule, they may argue, allows transfer pricing issues to develop, and is not in line with the 10 percent test generally applied to corporations other than banks.

Advocates of the current 30 percent test argue that it is not comparable to the 10 percent test applied to corporations other than banks. They also argue that transfer pricing problems are less prevalent in the lending of money than in the sale of goods, because comparable prices are easier to find for lending businesses. They also argue that intra-group transactions are more proper among banks than among other related parties.

Miscellaneous rules

Proponents of the current rules encouraging deposits in U.S. banks argue that these rules help capital formation in the United States.

Opponents of these rules argue that they do not necessarily encourage retention of capital in the United States because banks are free to lend these funds to foreign persons. They argue that banks should in any event bear more responsibility to insure depositors' compliance with U.S. tax laws.

D. Tax Exemption for Credit Unions

Present Law

Under present law, credit unions are exempt from Federal income tax regardless of whether their income is distributed as dividends.

Legislative History

State chartered credit unions have always been exempt from Federal income tax. Until 1951, the tax exemption for State-Chartered credit unions was subsumed under the tax exemption for savings and loan associations. When the exemption for savings and loan associations was terminated as part of the Revenue Act of 1951, the exemption for credit unions was continued in a separate Code provision. Federal credit unions have been exempt since enactment of the Federal Credit Union Act of 1934, which established federally chartered credit unions.

Issues

Originally, credit unions were exempted from tax along with savings and loan associations because both credit unions and savings and loan associations operated on a "mutual" basis (that is, on behalf of and for the benefit of their members), and not as separate profit-seeking entities. In addition, credit unions were generally small, unsophisticated financial institutions, operated by volunteers.

However, today there are many large credit unions, and credit unions offer depositors an array of services that are not always distinguishable from those offered by banks and savings and loan associations. Other types of mutual financial institutions, which compete with credit unions, are subject to tax on income not paid out to member-depositors as dividends. Furthermore, some credit unions appear to manage their asset portfolios so as to tap national capital markets. Some argue, therefore, that the credit union exemption should be reconsidered and credit unions be treated no differently than other thrift institutions.

Credit union representatives argue that they are unlike mutual savings and loan associations and mutual savings banks because they tend to be more closely controlled by their depositors, rather than by a board of directors. The law requires that a majority of the directors of a credit union receive no compensation and forbids proxy voting in credit union elections. These requirements, it is argued, ensure that credit unions, unlike other mutual institutions, will not operate like profit-seeking entities.

E. Deductibility of Dividends by Mutual Thrift Institutions

Present Law

Prior to 1952, mutual savings banks, cooperative banks, domestic building and loan associations and other savings institutions chartered and supervised as savings and loan or similar associations under Federal or State law were not subject to income tax. Since then, and under present law, these thrift institutions have become subject to the generally applicable provisions of the Code as well as some special tax rules.

In determining their taxable income, thrift institutions are allowed a special deduction from gross income for amounts paid to, or credited to the accounts of, depositors or holders of withdrawable accounts. Because these amounts are in the nature of interest, this deduction is allowed regardless of whether the amounts are denominated as dividends or interest. However, these amounts paid or credited must be withdrawable on demand, subject only to the customary notice of intention to withdraw. Thus, amounts paid as a dividend on the non-withdrawable capital stock accounts of a domestic building and loan association or a mutual savings bank are not deductible. Such a nondeductible dividend is a distribution out of earnings and profits as it is in the case of any other corporation.

The deduction for amounts credited as dividends or interest by thrift institutions is allowed in the taxable year in which such amounts become withdrawable by the depositor or accountholder. Thus, regardless of the accounting method used by the thrift institution, this deduction is not allowable on an accrual basis. The use of the "withdrawable" standard generally makes the deduction allowable when a cash-basis depositor or accountholder would include the amount in income, a question which may depend on the application of the constructive receipt principles and the provisions for recognizing accrual of original issue discount. Finally, the deduction is not denied because amounts that are credited, and otherwise deductible, are subject to the terms of a pledge agreement between the depositor or accountholder and the thrift institution.

Issues

Because a mutual thrift institution is theoretically operated for the benefit of its depositors or accountholders, conceptually such depositors or accountholders are not creditors in the same sense depositors of a commercial bank are considered to be. At the same time, however, the amounts credited to these accounts are in the nature of interest; they are derived from activities and are credited in a manner comparable to those used by commercial banks obligated to pay interest on funds on deposit. Thus, a member-depositor of a thrift institution might be considered to have a dual character, that of both an owner and a creditor. One suggestion is that shareholder-depositors be treated as owners to the extent that their dividends represent a reasonable rate of return on the equity capital of the institution. Thus, a percentage of dividends approximating this amount could be made nondeductible.

The present dividend deduction might be considered to follow a conduit theory as its model for taxing the income of a thrift institution. The thrift institution receives income on behalf of its depositor members; to the extent such income is distributed, because it is withdrawable on demand, only the depositors are taxed. However, by allowing a full deduction for amounts credited to withdrawable funds, the present provisions might be seen as failing to recognize the dual character of the depositor-members.

A similar situation, but a different tax approach, exists under present law for the treatment of policyholder dividends paid by mutual life insurance companies. Like thrift institutions, mutual life insurance companies are organized and operated for the benefit of their member-policyholders. However, under present law, a mutual life insurance company generally cannot deduct the full amount of the dividends it pays or credits to policyholders. For example, limitations temporarily in effect under the Tax Equity and Fiscal Responsibility Act of 1982 allow a mutual life insurance company to deduct 77½ percent of policyholder dividends paid during the year, whereas a stock life insurance company is allowed to deduct 85 percent. The 7½ percent difference for comparable deduction items has been referred to as the "profit differential" or "ownership differential" between mutual and stock companies engaged in the same business. Such a differential might be said to recognize, to some extent, the dual character of a policyholder in a mutual ife insurance company, that of both an owner and a policyholder. However, unlike an owner/depositor in a mutual thrift institution, an owner/policyholder in a mutual insurance company generally is not taxed on policyholder dividends credited to him.

Casualty insurance companies and mutual funds, however, are presently allowed a deduction for 100 percent of policyholder dividends.

Thrift institutions argue that most of their accounts are viewed by the depositors as deposits, not as equity interests in the institutions, and involve obligations virtually identical to those of a strict debtor-creditor relationship. Denying a deduction for part of the dividends paid by mutual institutions, therefore, would be unfair and could lead to income tax being paid by thrift institutions which, by ordinary standards, are in financial difficulty. Furthermore, a deduction denial would not necessarily raise very much revenue, since most accounts would be converted into interest-paying, not dividend-paying, status and would qualify for the ordinary interest deduction.

F. Miscellaneous Issues

1. Exemption From Straddle Provisions

Present Law

The Economic Recovery Tax Act of 1981 (ERTA) adopted a number of rules governing the tax treatment of straddles. Straddles consist of offsetting positions in actively traded personal property, other than stock. The measures adopted by ERTA were designed to prevent deferral of income, and in some cases the conversion of ordinary income or short-term capital gain into long-term capital gain, by closing positions on which a loss was sustained or by incurring deductible costs while delaying the closing of offsetting postions reflecting unrealized gain until a later year.

With respect to straddle transactions, these measures preclude the current deduction of certain interest charges and carrying costs, require the deferral of losses to the extent of unrealized gain on offsetting positions, and authorize regulations to apply rules comparable to the statutory wash sale and short sale rules to straddle transactions. In addition, all regulated futures contracts held by a taxpayer at the close of the taxable year are subject to tax as if they were then sold at their fair market value. This treatment follows the marking to market rules employed by the domestic futures exchanges. The mark to market rules were extended by the Technical Corrections Act of 1982 to cover certain contracts for the delivery of foreign currency that are traded in the interbank market.

Hedging transaction are excluded from the straddle rules, including the mark to market treatment of futures contracts and foreign currency contracts traded in the interbank market. A hedging transaction is one with respect to which both the hedge and the property hedged produce only ordinary income or loss and which is entered into in the normal course of the taxpayer's trade or business. In addition, if the taxpayer is not a bank (as defined in sec. 581), a transaction qualifies for the hedging exception only if it is entered into primarily (i) to reduce risk of price change or currency fluctuation with respect to taxpayer-held property, such as inventory, or (ii) to reduce risk of interest rate or price changes or currency fluctuations with respect to borrowings or obligations of the taxpayer.

Issues

The exemption of banks from these primary purpose requirements was intended to allow certain business activities which are regularly conducted by banks, but which may not be conducted primarily for risk reduction (for example, foreign currency trading), to be exempt from the straddle rules. It was argued that the straddle rules would be burdensome to banks and that banks do not typically engage in the transactions which would otherwise be subject to those rules for tax-avoidance purposes; therefore the banks should be exempt. However, other taxpayers who engage in non-tax-motivated business transactions may not qualify for the hedging exception and have requested that the special rule for banks be extended to them (e.g. market-makers in options).

2. Credit Card Start-up Costs

Present Law

Deductibility of start-up costs.—Under present law, ordinary and necessary expenses paid or incurred in carrying on a trade or business, or engaging in a profit-seeking activity, are deductible. Expenses incurred prior to the establishment of a business normally are not currently deductible since they are not incurred in carrying on a trade or business or while engaging in a profit-seeking activity.

Expenses or costs incurred in acquiring or creating an asset, e.g., a business, which has a useful life that extends beyond the taxable year normally must be capitalized. These costs ordinarily may be recovered through depreciation or amortization deductions over the useful life of the asset. However, costs which relate to an asset with either an unlimited or indeterminate useful life may be recovered only upon a disposition or cessation of the business.

5-year amortization of start-up costs.—In 1980, a provision (sec. 195) was enacted which allows business start-up cost expenditures to be amortized, at the election of the taxpayer, over a period of not less than 60 months beginning with the month the business begins. In general, expenditures eligible for this amortization must satisfy two requirements. First, the expenditure must be paid or incurred in connection with creating, or investigating the creation or acquisition of, an active trade or business entered into by the taxpayer. Second, the expenditure must be one which would be allowable as a deduction for the taxable year in which it is paid or incurred if it were paid or incurred in connection with the expansion of an existing trade or business in the same field as that entered into by the taxpayer.

Credit card costs.—Several courts have held that start-up fees incurred by banks to participate in a credit card system are deductible business expenses.[1] These expenses include such items as promotional and advertising costs, credit reports, operating manuals, and program costs.

Issues

The issue is whether start-up fees incurred by banks in starting in the credit card business should be treated as non-deductible start-up costs eligible for 5-year amortization.

On the one hand, it can be argued that the expansion by a bank into the credit card business should be viewed as the entry into a new business and the costs incurred should be required to be amortized since the business will generate income over a period of years. On the other hand, the entry into the credit card field may be viewed as an expansion of the existing lending business and the otherwise deductible start-up costs should be treated the same as those in other expanding businesses.

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[1] *Colorado Springs National Bank* v. *U.S.*, 505 F.2d 1185 (10th Cir. 1974);
First Security Bank of Idaho v. *U.S.*, 592 F.2d 1050 (9th Cir. 1979), *aff'g* 63 T.C. 644 (1975);
Iowa-Des Moines National Bank v. *Commr.*, 592 F.2d 433 (8th Cir. 1979), *aff'g* 68 T.C. 872 (1977).

3. Special Rules Involving Reorganizations of Financially Troubled Thrift Institutions

Present Law

In 1981,[1] Congress enacted several relief provisions designed to aid the then-ailing thrift industry. These provisions facilitate tax-free reorganizations of troubled thrifts, relax loss carryover rules, exclude from income recapture amounts when thrifts make certain distributions to the FSLIC, and liberalize the rule applicable when the FSLIC contributes to the capital of certain thrift institutions.

Tax-free reorganizations

Present law contains special rules designed to facilitate reorganizations of financially troubled thrift institutions undertaken under the jurisdiction of the Federal Home Loan Bank Board (FHLBB) or Federal Savings and Loan Insurance Corporation (FSLIC) (or, if neither has supervisory authority, an equivalent State authority). Institutions to which this rule applies are savings and loan associations, cooperative banks, and mutual savings banks (i.e., thrift institutions to which sec. 593 applies). The continuity of interest doctrine (which requires that shareholders of the acquired corporation must continue to have an interest, through stock ownership, in the successor corporation) does not apply to such reorganization transactions. With respect to such thrift institution reorganizations, there is no requirement that stock or securities in the transferee corporation must be received or distributed in the transaction. Substantially all the assets of the transferor, however, must be acquired by the transferee and substantially all the liabilities of the transferor, including deposits, immediately before the transfer must become liabilities of the transferee.

Loss carryovers

In general, if one corporation acquires another in a reorganization and the other corporation has a net operating loss, and certain other requirements are met, the net operating loss of the loss corporation must be reduced (section 382(b)). However, in applying this rule to the reorganization of thrift institutions which has been certified by FHLBB or FSLIC deposits in the acquired corporation which become deposits in the transferee corporation are treated as stock of both corporations. Thus, the loss limitation rule has reduced application in the case of the reorganization of a savings and loan association.

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[1] The Economic Recovery Tax Act of 1981, sections 241-244 and 246, effective for taxable years after 1980.

Distributions out of bad debt reserves

In general, when a savings and loan association makes a distribution to its shareholders out of excess bad debt reserves (i.e., in general, the excess of the reserve for losses on qualifying real property loans over the reserve which would have been allowable under the experience method), it must report that amount as ordinary income (section 593(e)). This recapture rule does not apply, however, to distributions to the FSLIC in redemption of an interest in a thrift institution received in exchange for financial assistance.

FSLIC contributions to savings and loan associations

Contributions to capital by nonshareholders are excluded from the income of the recipient corporation (sec. 118), but the basis of property is reduced by such contributions (sec. 362(c)). However, a savings and loan association need not reduce basis for money or property contributed to it by the FSLIC under its financial assistance program.

Issues

These provisions were designed to assist FHLBB and FSLIC in reorganizing financially troubled thrift institutions at a time when there was concern over the survivability of many thrift institutions. In effect, they reduce the direct outlay cost to FSLIC of subsidizing reorganizations by substituting more favorable tax treatment for direct outlays. In 1981, this may have been justified by the extremely serious problems which might have been created had it been necessary to enact additional appropriations for FSLIC in the event that depositors become concerned over the solvency of FSLIC and withdrew deposits from some institutions.

However, the question arises how long these provisions will be needed now that interest rates have fallen and the health of the thrift industry has improved. The banking industry has suggested that it be made eligible for similar treatment. Congress may, therefore, want to consider some sunset date for these provisions before they become a precedent for other industries.

Some would argue that the reorganization provision (with respect to the continuity of interest doctrine) clarifies the treatment of thrift reorganizations and should be retained, even if other ERTA amendments benefiting the thrift industry are limited or repealed.

4. Foreclosure on Property Securing Loans

Present Law

In general, foreclosure by a creditor on property in which the creditor holds a security interest is a taxable event to the creditor. First, the creditor may realize a deductible bad debt loss on the foreclosure if part or all of the debt foreclosed upon is worthless. Second, if the creditor acquires the property at the foreclosure sale, he may recognize gain or loss on the foreclosure if the property foreclosed upon has a fair market value more or less than his basis in the amount of the debt for which the creditor purchased the property. This is because the creditor is treated as disposing of the debt in exchange for the fair market value of the property foreclosed upon. Later, if the property is disposed of in a taxable event, additional gain or loss may be recognized.

Since the Revenue Act of 1962 special treatment has been provided, however, for thrift institutions which acquire any property which is security for payment of a debt. If a thrift institution forecloses on the security for a debt owed to the institution (or otherwise reduces the property to ownership or possession by any process of law or by agreement), no gain or loss is recognized and no debt is considered as having become wholly or partially worthless regardless of the property's fair market value at the time of the foreclosure. Instead, the loan transaction is held open and the property received in the foreclosure (or other proceeding) is treated for tax purposes as having the same characteristics as the debt for which it was security.[2] The basis of the acquired property is equal to the institution's adjusted basis in the debt, increased by the costs of acquisition.

While, under this provision the acquisition of the security by foreclosure (or other legal means) is not itself a taxable event to a thrift institution, foreclosure may still have tax effects in the taxable year of foreclosure or later taxable years. For example, if the property foreclosed upon has depreciated in value below the thrift institution's basis in the property (generally the amount of the debt outstanding at the time of the foreclosure, adjusted for acquisition costs), the decline may be charged against the bad debt reserve of the institution (if that is proper under the institution's method of accounting), and the basis of the property reduced accordingly. If the property continues to decline in value, further loss deductions may be taken.

When the property is later disposed of, the amount realized is treated as a payment on the debt (closing the loan transaction). Thus, the disposition will generally generate either ordinary income (or a credit to the appropriate bad debt reserve account), or a bad debt loss at that time. Any income generated by the property and any deductions (other than depreciation) allocable to the property, retain their characteristics as rent, royalties, *etc.*

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[2] Thus, no depreciation deduction is allowable with respect to the acquired property.

This treatment is mandatory if the institution is a thrift institution in the taxable year of the foreclosure. For this purpose, a thrift institution is any mutual savings bank not having capital stock represented by shares, a stock savings bank which is regulated like a mutual savings bank, a savings and loan association, or a cooperative bank without capital stock organized and operated for mutual purposes and without profit.

Issues

Under pre-1962 law, if a thrift institution acquired property at a foreclosure sale for an amount less than the unpaid debt, a loss deduction was allowable (if the excess was otherwise uncollectable). Further, a gain or loss could result on foreclosure if the property had a fair market value different from the creditor's basis in the amount of the loan bid at the foreclosure sale. In the case of the later sale or other disposition of the property, a third recognition event could occur. This provision eliminated these erratic results with respect to thrift institutions. It also discourages foreclosures to obtain depreciation deductions, which the law prior to 1962 may have encouraged. However, this provision provides thrift institutions with tax treatment different from that provided other taxpayers such as commercial banks. Some have suggested, therefore, that the treatment of thrift institutions acquiring property on foreclosure (or other legal means) be conformed with the treatment given other taxpayers (or vice versa).

5. Loss Carryback and Carryover Rules

Present Law

In general, for net operating losses arising in taxable years ending after 1975, taxpayers are permitted to carry a net operating loss back to the 3 taxable years preceding the loss year and forward to the 15 taxable years following the year of the loss. Commercial banks (and thrift institutions) are given different net operating loss treatment than taxpayers in general. Commercial banks, small business investment companies, housing development corporations, and certain thrift institutions are permitted to carry a net operating loss back to each of the 10 taxable years preceding the loss year and forward to each of the 5 taxable years following the year of the loss.

Legislative History

The extended loss carryback for banks, savings and loan associations and mutual savings banks was enacted in 1969, the same year that their bad debt reserves were reduced.

Issues

Generally, taxpayers will prefer a loss carryback to a carryforward because the carryback enables them to obtain an immediate refund while the carryforward only provides the possibility of a tax reduction in the future. Financial institutions argue that the volatility of their business, and the serious problems that arise for the national economy when they experience losses, justifies their receiving a longer carryback period than other businesses. They also argue that their ability to average income and losses over a 16-year period, rather than the 19-year period given to ordinary businesses, put them at a disadvantage and have suggested that they be given an 8-year carryforward.

Others argue that there is no valid reason why financial institutions should have different carryover and carryback rules than other businesses.

STATEMENT OF SENATOR DOLE

Today's hearing is an initial effort to ask—and hopefully answer—the question whether commercial banks, thrift institutions, and credit unions are bearing their fair share of the income tax burden.

I frankly admit that I do not know whether the tax preferences, and other tax provisions, used by many of these financial institutions are unwarranted, inefficient, or too generous. That is why I am interested in hearing the testimony of our distinguished witnesses today.

There are certain facts that are inescapable, however.

First commercial banks enjoy an usually low effective tax rate on their U.S. income. In 1981, a sample of twenty large commercial banks studied by the staff of the Joint Committee enjoyed an average effective tax rate of 2.3 percent. In contrast, the average effective tax rate for individuals was in the range of 20 percent, and many industries had effective tax rates higher than thirty or forty percent. In all fairness, I should point out that many large corporations appear to enjoy effective tax rates lower than the statutory corporate tax rate of 46 percent. But even among other large corporations, commercial banks enjoy an exalted position in terms of their ability to reduce their effective tax burden.

Second, financial institutions enjoy special tax preferences that are not shared by other industries. Banks, for example, are generally permitted to deduct interest paid to carry tax-exempt securities, a privilege not enjoyed by other taxpayers. Savings and loans enjoy special loan loss provisions, and credit unions enjoy complete exemption from Federal income taxation, regardless of whether their income is distributed as dividends. That means that a credit union is not only better off than a business corporation subject to the corporate income tax; credit unions are also better off than consumer cooperatives who can avoid income taxation only if they distribute all of their current income to their members. While many credit unions are small, their ability to accumulate income free of tax has undoubtedly contributed to their rapid growth. In 1981, for example, the ten largest credit unions each had assets greater than $200 million, and the two largest credit unions, the Navy Federal Credit Union, and the Pentagon Federal Credit Union, had assets of $949 million and $554 million respectively.

REVIEWING TAX PREFERENCES

Many of the special provisions and tax preferences enjoyed by financial institutions undoubtedly had some justification when they were first placed in the law. But Congress has a responsibility to reexamine these preferences, and determine whether they can now be justified, in light of the much higher effective tax rates borne by most other business and individuals.

In conducting such a review, the answers are by no means preordained. It is clear that the ownership of tax-exempt bonds is a very significant factor contributing to the low tax rates of many commercial banks. But our Committee may well decide that the preferences that give banks a special incentive to invest in tax exempt bonds should be retained, despite the inefficiency, and windfalls for bond holders, that have been associated with this method of assisting States and local governments.

On the other hand, a recent article in the "Weekly Bound Buyer" suggested that certain changes in the taxation of commercial banks, such as the enactment of a corporate surcharge similar to that proposed by President Reagan, could improve the market for tax-exempt bonds, by making them more attractive to the banks.

According to the analysis of Gerald Roberts, Vice President of the securities firm of Smith Barney Harris Upham & Co., Inc., an increase in the statutory tax rate for banks, from 46 percent to 51 percent would result in a 94 basis point increase in the after-tax yield of municipal bonds. Changes of this nature, this securities expert has said, could not only raise revenue, but also improve the attractiveness of municipal bonds, to the benefit of the issuing governments. Clearly, our Committee must not only review issues carefully but consider a variety of alternative approaches, if we conclude that changes in the tax law are warranted.

REVIEW OF USER TAXES FOR FINANCIAL INSTITUTIONS

One issue the Committee may review, is whether income taxation is the best method of insuring that financial institutions pay their fair share of the Federal tax burden, especially when the Federal Government is called upon to bear the cost of certain governmental programs and activities of particular benefit to the financial industry.

In the recent post-election session of the 97th Congress, the Surface Transportation Assistance Act of 1982 increased the user taxes on gasoline, certain tires, and certain trucks, to contribute to the important national task of repairing our Nation's highways and bridges. It may be appropriate for the Committee to review the possibility of imposing similar user taxes, in addition to the income tax, to support governmental programs of significance to the financial industry.

Congress will soon be considering the Administration's request to increase our quota authority with the International Monetary Fund by $8.5 billion. I do not believe that this proposal is a bail-out for the banks, as some have suggested. By the same token. I do not believe that last December's highway repair bill was a bail-out for the nation's drivers, truckers, and other highway users. Perhaps it would be appropriate, however to consider asking the nation's commercial banks to pay a user tax, possibly an excise tax related to the size of their deposits, to contribute a greater share to the cost of participating in the International Monetary Fund. Although I am a strong supporter of our continued participation in the IMF, I was surprised to discover the relationship between the cost of our participation, and the amount of taxes paid by commercial banks. According to the Treasury Department, our participation in the IMF cost the Treasury an average of $107 million each year, over the last 13 years. But in 1982 our participation cost $528 million and in 1981 it cost $1.5 billion. These recent cost figures may be extraordinary, and may not indicate a trend of growing cost. But it is noteworthy that our participation in the IMF in 1981, cost the Federal Government more than the entire amount of Federal income taxes paid by all commercial banks in 1980, the most recent year for which statistics are available.

No user tax should be a substitute for a fair income tax. And certainly, no tax should be considered that would discourage the future foreign lending which is needed to help resolve the current international debt problem. But the possibility of extending the user tax concept from truckers to bankers should be explored. I believe this is particularly appropriate since the study prepared by the staff of the Joint Committee on Taxation indicates that while a group of the 20 largest banks paid only 2.3 percent of their income in taxes, a group of the largest trucking companies paid over 46 percent of their income in taxes.

I look forward to hearing the testimony of our distinguished witnesses.

100 LARGEST CREDIT UNIONS IN THE U. S.*

Ranked by Size of Assets December 31, 1981

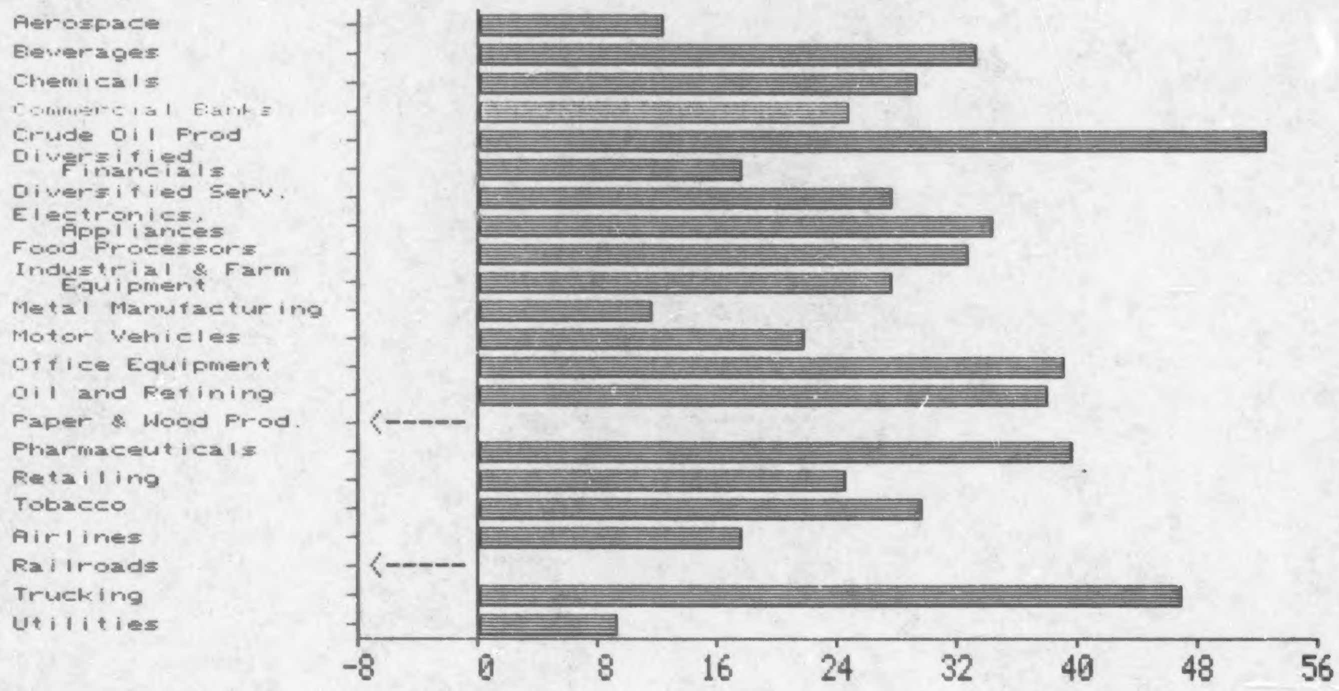
Compiled by **American Banker** Copyright 1982

Rank 12/31 1981	Dollar Amounts in Thousands	Insurance Type(s)	TOTAL ASSETS 12/31/81	TOTAL ASSETS 12/31/80	Rank 12/31 1980	Gain in Rank	Member Savings (a) 12/31/81 $	Share Draft 12/31/81 $	No. of Reg. Share Accounts (b) 12/31/81	No. of Share Draft Accounts 12/31/81	Dividend Rate (c) 12/31/81 %
1	Navy FCU, Washington, D.C.		948,991	896,194	1		838,709*	74,999	857,040	117,871	10.380
2	Pentagon FCU, Arlington, Va.		664,938	632,837	2		606,883	0	299,933	0	16.880
3	State Employees CU, Raleigh, N.C.	3	463,767	422,366	3		383,394	29,827	130,000	28,000	13.870
4	Government Employees CU, San Antonio, Tex.	2	447,822	383,882	4		382,410	44,343	136,129	47,198	12.890
5	Alaska USA FCU, Anchorage		390,937	366,948	6	+ 1	366,034	47,436	141,229	39,979	12.900
6	United Air Lines Employees CU, Chicago	3	347,206	361,138	5		337,896	0	63,836	0	—
7	Eastern Airlines Employees FCU, Miami		323,878	302,717	7		282,863	38,069	63,373	15,987	14.000
8	Construction Equipment CU, Peoria, Ill.	2	292,814	279,752	9	+ 1	270,874	16,909	98,413	22,299	12.000
9	Hughes Aircraft Employees FCU, El Segundo, Calif.		279,581	283,738	8		255,307	21,777	83,075	18,813	13.000
10	Telephone Empl. CU of So. Calif. Ltd., Los Angeles	3	216,418	197,178	12	+ 2	194,881	13,794	98,816	13,986	16.400
11	Boeing Employees CU, Seattle	2	215,286	199,793	11		190,489	8,210	83,068	6,362	13.500
12	Lockheed FCU, Burbank, Calif.		201,778	195,000	13	+ 1	190,486	16,573	65,000	10,861	N.A.
13	Tinker CU, Tinker A.F.B., Oklahoma City	2	200,751	180,599	16	+ 3	178,777	28,510	85,966	25,317	14.300
14	Golden One CU, Sacramento, Calif.	2	200,048	182,790	15	+ 1	184,811	14,078	89,841	30,400	13.000
15	American Airlines Employees CU, Queens, New York	2	195,817	204,329	10		172,087	0	42,801	0	12.400
16	Federal Employees CU, Riverdale, Utah	2	187,124	162,036	20	+ 4	169,591	6,091	84,163	11,977	14.400
17	IBM Poughkeepsie Employees FCU, N.Y.		181,651	166,369	19	+ 2	171,248	11,913	59,233	16,799	14.400
18	San Diego Navy FCU, Calif.		178,266	186,087	14		170,247	15,800	137,008	13,808	16.202
19	Dearborn FCU, Mich.		166,230	178,482	17		156,816	26,129	86,816	36,387	16.886
20	Los Angeles Teachers CU	2	157,877	173,180	18		136,073	7,286	27,343	7,884	—
21	LMSC FCU, Sunnyvale, Calif.		156,616	157,439	22	+ 1	141,349	4,314	38,678	3,787	13.875
22	Jax Navy FCU, Jacksonville, Fla.		155,095	141,962	27	+ 5	141,969	13,681	78,232	10,196	14.466
23	TWA Club CU, Kansas City, Mo.	2	154,116	159,333	23		141,258	0	36,536	0	—
24	Monsanto Community CU, St. Louis, Mo.	2	152,242	77,499	87r	+63	143,446	8,487	21,389	7,287	16.500
25	Eglin FCU, Ft. Walton Beach, Fla.		151,797	159,713	21		121,132	12,639	72,999	16,539	16.000
26	Marquette CU, Woonsocket, R.I.	3	146,060	129,722	35	+ 9	139,287	3,599	49,751	6,183	N.A.
27	Security Service FCU, San Antonio, Tex.		146,496	147,107	24		136,102	16,439	97,812	16,347	13.500
28	Dallas Teachers CU	3	143,764	136,341	30	+ 2	134,615	3,870	72,839	3,348	14.300
29	Government Employees Credit Union of El Paso, Tex.	2	143,170	128,296	39	+ 10	128,161	16,096	47,491	15,081	14.500
30	Texins CU, Dallas	2	141,234	142,346	26		133,011	14,516	N.A.	17,961	12.000
31	CTA CU, Burlingame, Calif.	2	140,604	130,820	31		68,337	5,813	48,382	6,373	13.800
32	Bethpage FCU, N.Y.		139,910	129,529	36	+ 4	107,080	13,090	48,536	12,423	14.000
33	Rockwell FCU, Downey, Calif.		137,320	137,661	29		124,480	4,565	61,008	4,843	13.750
34	IBM Endicott Owego Employees FCU, Endicott, N.Y.		134,589	84,166	70	+ 36	125,228	12,377	64,115	17,248	14.000
35	Tower FCU, Annapolis Junction, Md.		133,762	128,409	38	+ 3	124,466	14,318	47,567	16,066	14.466
36	Iron & Steel CU, Birmingham, Ala.	2	133,463	119,293	42	+ 6	122,864	8,300	58,570	9,833	15.000
37	Northwest FCU, Vienna, Va.		133,127	130,284	34r		124,430	2,100	N.A.	N.A.	13.000
38	Orange County Teachers CU, Santa Ana, Calif.	2	132,335	130,780	32		91,067	1,767	35,969	2,229	13.500
39	McDonnell Douglas West FCU, Torrance, Calif.		132,041	143,213	25		119,069	1,884	36,868	2,084	14.300
40	Delta Employees CU, Atlanta	3	130,440	127,576	37		124,417	1,076	42,772	1,880	—
41	California Teachers FCU, Los Angeles		129,390	123,310	40		110,313	12,371	75,189	12,891	13.000
42	Lockheed Georgia Employees FCU, Marietta		128,489	119,696	41		123,162	3,914	33,835	3,518	16.500

43	Rockland CU, Mass.	3	127,836	119,262	43		118,032	4,334	86,348	9,290	7.000
44	East Hartford Aircraft FCU, Conn.		126,575	130,722	33		94,075	3,029	72,000	6,137	N.A.
45	State Employees Credit Union of Maryland, Inc., Towson	3	126,167	114,075	45		119,116	0	99,263	0	.....
46	State Department FCU, Arlington, Va.		126,165	113,961	48		100,791	9,463	39,979	6,985	15.890
47	Redstone FCU, Huntsville, Ala.		123,182	132,326	31		116,784	20,676	53,066	17,346	12.000
48	Suncoast Schools FCU, Tampa, Fla.		120,757	107,857	47		110,839	4,428	48,213	6,964	12.690
49	Andrews FCU, Camp Springs, Md.		117,804	117,464	44		113,401	10,616	64,641	11,258	15.568
50	Randolph Brooks FCU, Universal City, Tex.		114,936	96,126	56	+6	107,177	15,011	49,832	14,436	16.550
51	Georgia Telco CU, Atlanta	3	111,003	104,405	51		104,395	2,274	44,966	3,534	12.610
52	Travis FCU, Travis A.F.B., Calif.		106,347	104,844	50		88,706	8,238	45,600	8,882	15.182
53	Robins FCU, Warner Robins, Ga.		105,183	94,350	60	+ 7	94,706	3,232	54,272	5,014	14.011
54	Blue Hill CU, Brookline, Mass.	2	104,970	102,550	53		96,127	2,324	17,823	2,614	11.500
55	Litton Employees FCU, Canoga Park, Calif.		102,196	99,536	55		94,512	12,450	60,296	14,019	13.900
56	Teachers CU, South Bend, Ind.	2	100,926	82,871	74	+ 18	95,393	9,261	49,050	17,169	16.550
57	St. Louis Telephone Employees CU, Mo.	2	97,975	34,165	...		96,522	3,807	21,626	5,767	16.550
58	Municipal CU, New York	2	97,549	98,442	57		87,795	0	123,465	0	.....
59	Wright-Patt CU, Inc., Fairborn, Ohio	2	96,493	105,386	49		86,844	11,430	70,871	15,085	12.610
60	School Employees CU, Sacramento, Calif.	2	96,754	103,000	52		70,453	8,256	54,196	11,471	15.000
61	Bellco CU, Denver	2	95,266	99,996	79	+ 18	83,873	6,366	29,730	6,563	15.818
62	Eastman CU, Kingsport, Tenn.	3	94,474	77,774	85	+ 23	88,365	0	19,745	0	13.871
63	Maxwell-Gunter FCU, Montgomery, Ala.		94,391	84,429	69	+ 6	87,492	10,686	50,069	N.A.	14.300
64	Detroit Teachers CU, Mich.	2	94,120	91,581	62		95,833	5,721	56,404	9,488	14.330
65	Inland Employees CU, East Chicago, Ind.	2	94,018	83,187	71	+ 6	86,371	483	27,763	955	12.698
66	Pan American FCU, Queens, New York		93,835	92,362	61		86,514	4,624	19,526	4,711	12.000
67	LTV FCU, Grand Prairie, Tex.		93,216	77,160	88	+ 21	74,260	4,684	32,273	5,590	15.570
68	ENT FCU, Colorado Springs, Colo.		92,767	94,879	58		85,986	10,987	46,291	11,356	14.000
69	FAA Western FCU, Los Angeles		92,311	101,256	54		87,912	10,022	36,370	18,243	12.700
70	S.A.F.E. FCU, North Highlands, Calif.		92,251	86,362	80	+10	84,641	6,566	37,661	6,782	12.000
71	Municipal Employees Credit Union of Baltimore, Inc.	3	91,303	87,996	65		78,449	415	41,367	1,105	10.000
72	Washington School Employees CU, Seattle	3	91,000	106,565	48		83,000	16,000	56,000	15,000	N.A.
73	Bank Fund Staff FCU, Washington, D.C.		90,107	81,846	76	+ 3	85,016	8,824	11,783	2,271	12.698
74	Charleston Naval Shipyard FCU, S.C.		89,800	74,996	93	+ 19	82,881	9,843	54,196	14,515	12.660
75	Los Angeles Water & Power Employees CU	2	88,127	88,600	64		82,064	3,446	48,477	3,337	12.140
76	Mather FCU, Sacramento, Calif.		87,000	96,721	58		52,000	8,000	42,000	8,000	16.104
77	Knoxville TVA Employees CU, Tenn.	3	86,502	96,718	59		79,907	N.A.	N.A.	N.A.	N.A.
78	Kern Schools FCU, Bakersfield, Calif.		86,171	83,006	73		78,483	5,051	37,662	7,466	14.000
79	Langley FCU, Hampton, Va.		86,030	80,987	77		76,018	9,611	37,848	7,093	14.000
80	Mission FCU, San Diego, Calif.		84,622	66,731	116	+ 36	65,237	5,873	26,121	5,061	16.200
81	Keesler FCU, Keesler A.F.B., Miss.		84,261	79,073	83	+ 2	74,822	11,666	64,431	25,967	14.279
82	Aberdeen Proving Ground FCU, Md.		82,473	77,595	86	+ 4	76,765	5,301	29,863	6,793	12.000
83	Los Angeles City Employees FCU		81,967	75,301	92	+ 9	71,999	N.A.	N.A.	N.A.	N.A.
84	North Island FCU, San Diego, Calif.		81,700	70,666	109	+ 25	73,746	9,375	57,716	11,923	15.000
85	Pen Air FCU, Pensacola, Fla.		81,703	78,109	84		73,536	6,529	57,336	10,451	.....
86	Desert Schools FCU, Phoenix, Ariz.		81,190	80,845	78		75,756	5,006	52,359	7,537	16.550
87	Portland Teachers CU, Ore.	2	80,816	79,257	82		73,715	2,896	51,634	3,854	14.000
88	Utah State Employees CU, Salt Lake City	2	80,611	80,179	63		77,039	5,212	44,481	7,775	13.200
89	Los Angeles Firemen's CU	2	80,582	82,905	75		75,056	3,350	12,212	2,170	14.500
90	Fort Monmouth FCU, N.J.		79,957	56,061	147r	+ 57	67,424	6,957	42,654	9,378	16.550
91	ORNL FCU, Oak Ridge, Tenn.		79,936	76,553	89		74,585	6,515	16,678	7,148	N.A.
92	John Deere Employees CU, Waterloo, Iowa	2	79,342	64,899	121	+29	71,947	6,341	30,464	9,978	14.000
93	66 FCU, Bartlesville, Okla.		78,764	79,906	81		75,852	3,639	23,578	3,800	13.500
94	TRW Systems CU, Redondo Beach, Calif.	2	78,448	85,046	67		74,484	3,000	44,131	4,033	14.500
95	IBM Interstate Employees FCU, Rye, N.Y.		78,339	71,114	104	+ 9	69,064	17,130	27,832	12,857	14.300
96	Northrop CU, Hawthorne, Calif.	2	78,129	87,180	66		70,743	3,056	38,502	3,600	14.000
97	Los Angeles Police CU	2	77,244	73,985	95		53,454	N.A.	N.A.	N.A.	N.A.
98	Chattanooga TVA Employees FCU, Tenn.		77,079	83,039	72		68,417	3,116	24,609	4,480	14.550
99	Brockton CU, Mass.	3	76,033	72,448	100	+ 1	66,757	0	25,000	0	16.550
100	Nellis FCU, Nellis A.F.B., Nev.		75,886	74,621	94		69,989	5,154	41,433	5,300	12.500

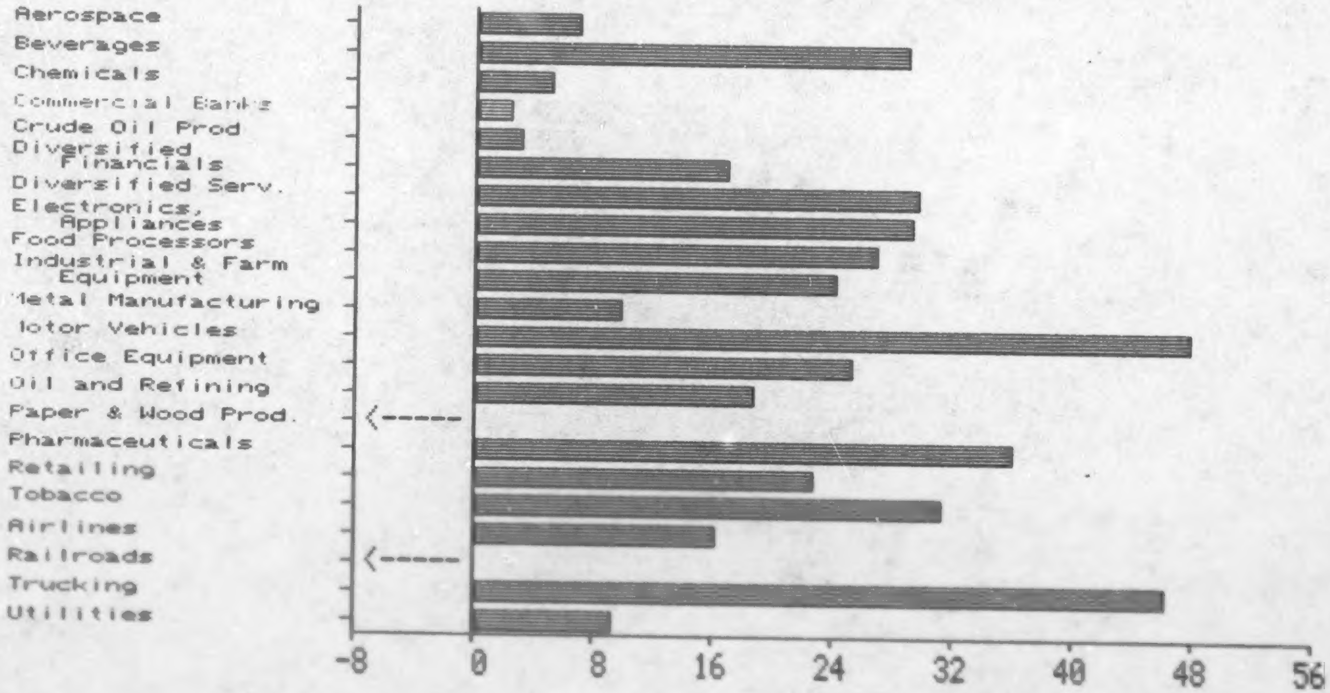
*—Excludes Corporate Central Federal Credit Unions and State Central Credit Unions. (a)—Includes share capital, share drafts, deposits and investment certificates. (b)—Excludes share draft accounts. (c)—Most common rate paid on money market and share certificates, based on largest dollar volume of such certificates. (d)—Insurance Type. The state-chartered credit unions in the above listing have their members' savings insured as follows: 2=NCUA insured; 3=Insured by a state agency; 4=non insured. All federally chartered credit unions (FCU's) are insured by the NCUA. N.A.—Not available. r—Rank that CU would have had if it had been included in [illegible].

Federal Corporate Income Tax Rates Of Selected Companies By Industry, 1981
Worldwide Tax Rate On Worldwide Income



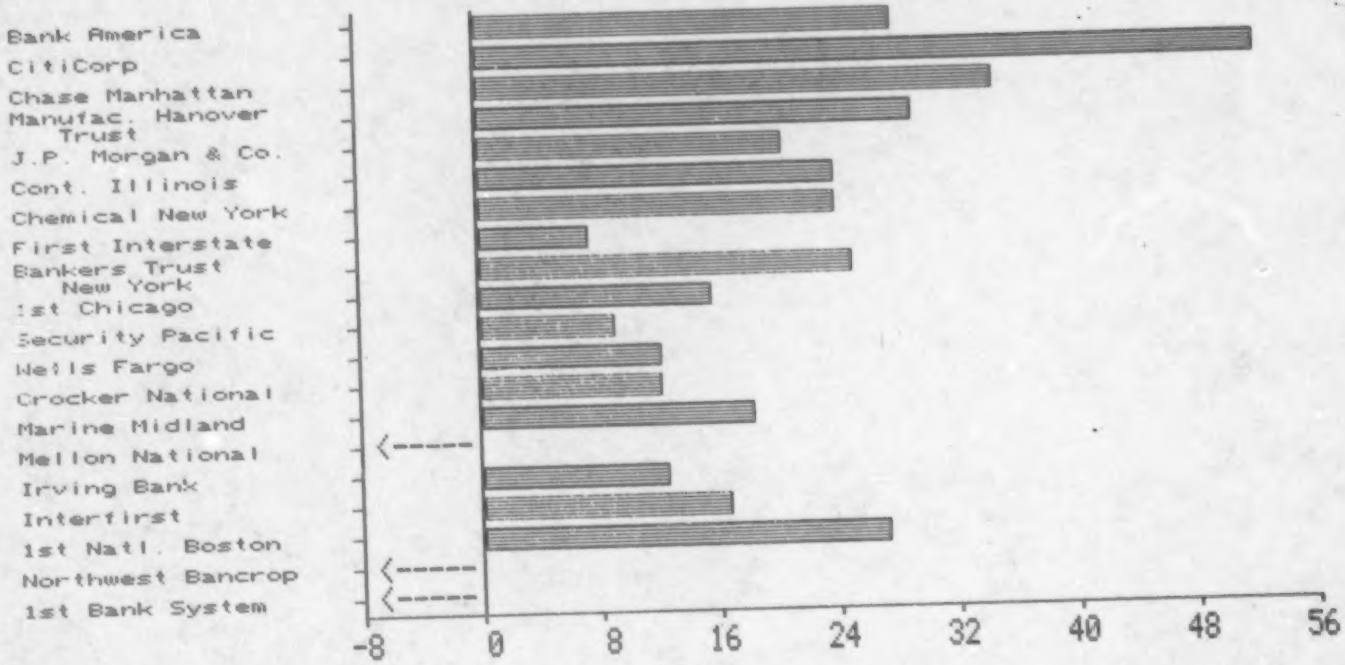
Graphics by H.I.S.

Federal Corporate Income Tax Rates Of Selected Companies By Industry, 1981
U.S. Tax Rate On U.S. Income



Graphics by H.I.S.

Federal Income Tax Rates For Large Commercial Banks, 1981
Worldwide Tax Rate On Worldwide Income



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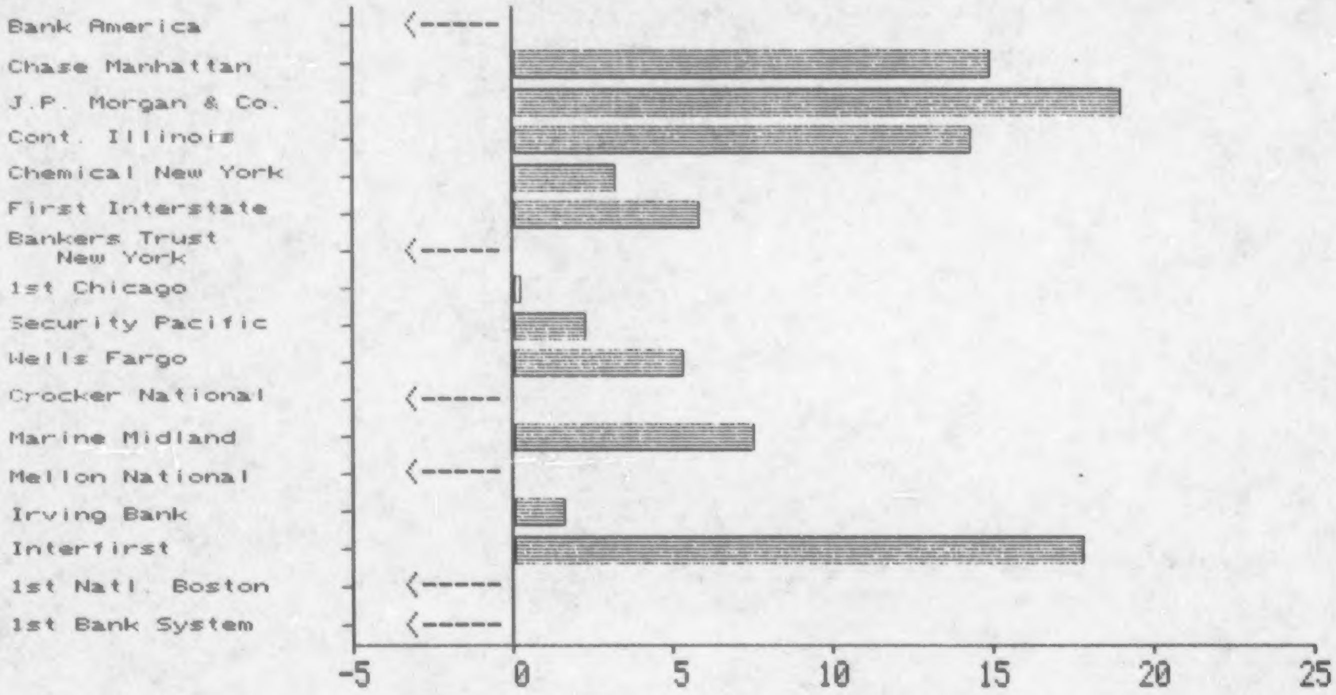
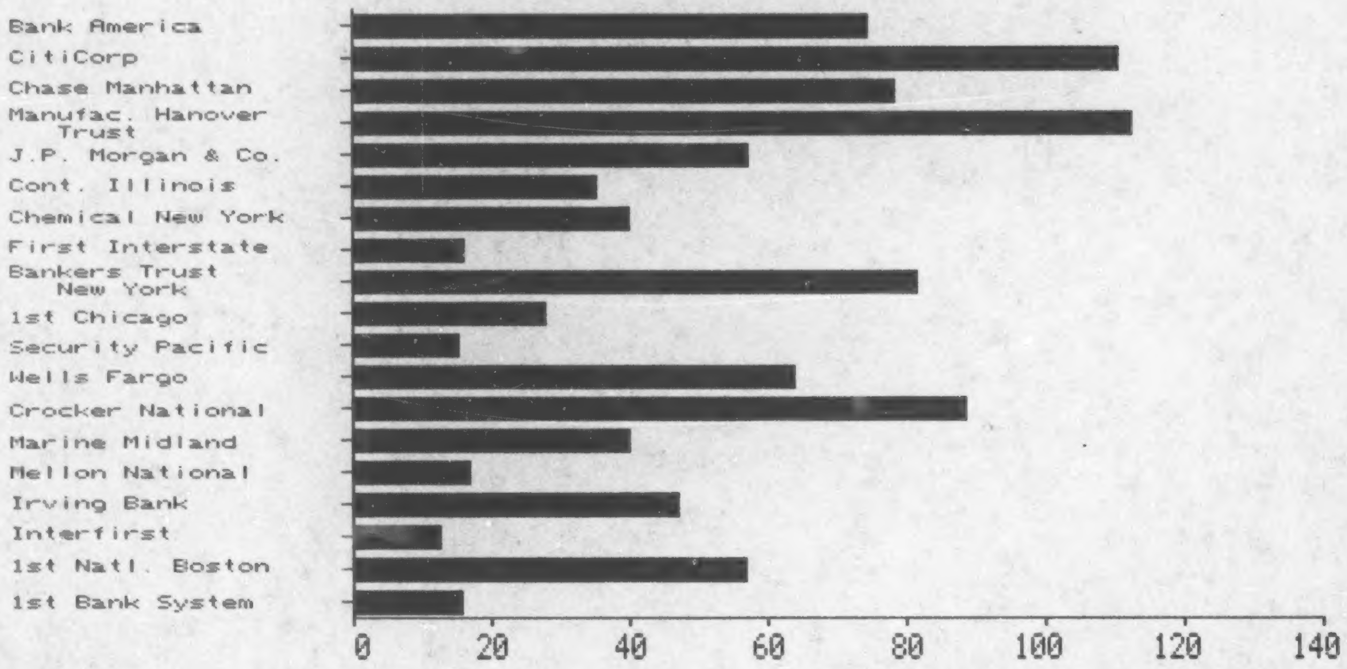
Federal Income Tax Rates For Large Commercial Banks, 1981
U.S. Tax Rate On U.S. Income



Graphics by H.I.S

Foreign Source Income As Percentage Of Worldwide Income
For Large Commercial Banks, 1981



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Example on Tax-Exempt [redacted]

[illegible]

Suppose cost of funds is 9%, and can earn 10% in taxables but only 8% on tax exempts (consistent with the present 15% to 25% reduced yield on long term bonds). In case number 1, the bank invests all of its assets ($1,000) in taxable obligations. In case number 2, the bank invests 90 percent of its assets ($900) in taxable obligations and 10 percent of its assets ($100) in tax-exempt obligations.

	Case number 1	Case number 2
Investments	$1,000 taxable bonds	$900 taxable $100 tax-exempt
Total Income	$100 ($1,000 at 10%)	$98 ($900 at 10% plus $100 at 8%)
Income subject to tax	$100	$90
Cost of funds	$ 90	$90
Taxable income	$ 10	$ 0
Tax	$ 4.60	$ 0
After-tax income	$ 5.40	$ 8

So, at cost of $2 in loss of income, an investment in tax-exempt obligations reduces taxes from $4.60 (a 46 percent tax rate) to zero. Note also that, even though the bank appears to lose money on the investment in tax-exempt obligations (income yield of 8 percent compared to a 9 percent cost of funds), the bank's after-tax return is increased through its investment in tax-exempt obligations. The reduced before-tax income of $2 from investing in tax-exempt obligations is a burden arising from the tax system that is passed on to the borrower of the tax-exempt obligations. For simplicity, this example ignores the 15% disallowance of deductions for interest incurred to carry tax-exempt bonds.

Foreign tax credit for gross withholding tax

Assume a 10% interest rate (adjusted to take into account all risk factors), cost of funds is 9%, and a foreign country which imposes a gross withholding tax of 20% of interest paid.

	Treasury absorbs tax	Foreign borrower absorbs tax
A. Bank able to use credits		
Interest charged	10%	12.5%
Tax withheld	2%	2.5%
After tax yield to bank after FTC	10%	12.5%
After foreign tax profit	1%	3.5%
B. Bank in excess credits position		
Interest charged	10%	12.5%
Tax withheld	2%	2.5%
After tax yield	8%	10%
After foreign tax profit (loss)	(-1%)	1%

The **CHAIRMAN**. The hearing today will be on the taxation of banks, savings and loans, and credit unions.

We are pleased to have as our first witness the distinguished Senator from Ohio, Senator Metzenbaum.

[Senator Metzenbaum's prepared statement follows:]

STATEMENT BY SENATOR HOWARD M. METZENBAUM

Mr. Chairman, I am deeply concerned about what is happening to this country's tax policy. We are facing record high budget deficits of $200 to $300 billion. Yet this year we will collect 20 percent fewer dollars from the corporate income tax. And corporate income taxes as a share of GNP are expected to reach a post-world war II low of 1.3 percent.

What we see developing is an unfair sharing of the tax burden, pushing more and more on the individual taxpayer—and less and less on the corporations of this country.

Excluding payroll taxes, we have seen corporate income taxes go down from 31 cents out of every Federal tax dollar in 1950, to 12 cents in 1983.

The effective corporate tax rate fell from 50 percent in 1950 to 39 percent in 1980. According to the Congressional Budget Office the effective rate will continue to drop, reaching a new record low of 26.2 percent in 1988.

In industry after industry the pattern is clear. A Joint Tax Committee study reports that in 1981 the paper and wood products industry had U.S. income of almost $1.4 billion, yet received refunds or tax credits of $193 million.

Railroads had $1.7 billion in income, yet received refunds and credits totaling $129 million.

The top crude oil producers earned nearly $1 billion in income, but paid only $31 million in taxes, a 3.1 percent effective tax rate.

The chemical industry earned 3.1 billion dollars, but paid only 5 percent of that amount in taxes.

Last week, General Electric reported that it had earned $1.8 billion in 1982. Yet it received a tax refund of $146 million.

I don't criticize the corporation of this country for that. I was a businessman before I came to the U.S. Senate, and I know that no good business will pay more to the tax man than the law requires. But the fact is that there is something wrong with our tax system when large profitable corporations find that they don't have to pay any federal income taxes, and it is incumbent on us as legislators to remedy this situation.

I am not alone in this belief. Corporate income taxes have been cut so much that 16 Republican Senators wrote a letter to the President of the United States in which they said, "We are greatly concerned that by 1985 as many as half of all corporations may be paying no corporate income taxes." The letter went on to say, "it would be a mistake to allow such a situation to develop at a time when all citizens should be asked to assume their fair share of that burden.

Mr. Chairman, the low effective tax rate of financial institutions is an example of the problem we face.

In 1981, this country's 20 largest banks earned $1.9 billion in U.S. income, but paid $53 million in taxes, a 2.7 percent tax rate. Six banks had incomes ranging from $8 to $154 million but paid no taxes and received either tax refunds, or credits to reduce future tax liabilities. For example, the nation's second largest bank, Bank America, had income of $154 million but will either receive $18 million in refunds or reduce its future years' tax bills by the that amount.

Congress has enacted various provisions throughout the years—a bad debt deduction, a foreign tax credit, net operating loss carry-overs, and other provisions that at the time seemed to make sense. But in combination with one another, these tax provisions are today operating to reduce, and in many cases eliminate, the legitimate tax liability of the nation's largest banks.

Since 1951, for example, financial institutions have enjoyed an excess bad debt deduction. No other businesses have it. If other businesses have bad debts they write them off. But under this special provision, banks and other financial institutions are permitted to compute and deduct amounts far in excess of their actual losses.

What does it cost the Federal treasury?

Between now and the end of fiscal year 1988, that one item will reduce Federal revenues by $4.2 billion.

Last year's Senate Budget Committee report on tax expenditures indicated that this artificial bad debt reserve which is scheduled to expire in 1988, is a major reason why the bank pay such low effective tax rates. A year ago, however, the Treasury Department supported efforts to permanently keep the deduction at its 1981 level.

Is that still the administration's position?

The answer is "maybe."

Last month, when Secretary Regan testified before the Budget Committee, I asked him if the administration would continue to favor retaining the bad debt reserve.

His answer?

"I do not know. We have not made up our mind on a position."

I must say that I find it amazing that this administration has no trouble concluding that we need an excise tax on oil, an income surcharge, and new taxes on employer-provided health care. But when it comes to deciding whether or not the banks should retain a tax benefit that no other taxpayer enjoys, the administration just cannot decide.

And the bad debt reserve is only one of the special tax breaks tailored for the banking industry. In 1969, when Congress decided to phase out the bad debt reserve through 1988, the industry obtained for itself a new loophole. What we took away with one hand, we gave back with the other.

Let me explain how this provision works.

All companies which accumulate more tax writeoffs than they can use in a given year may apply these tax breaks against taxes paid in the three previous years to obtain a tax refund.

But banks?

Banks are special. They can receive refunds for taxes paid during the prior ten years.

What rationale can exist for this special treatment, The only one that I can find is that some industry lobbyist decided that if the banks were going to lose the artificial bad debt reserve, they should get a new loophole to take its place. And they did.

Financial institutions enjoy even more special interest tax breaks:

The tax code says that taxpayers may not deduct interest on obligations used to finance the purchase of tax-exempt securities. But the tax laws exempt banks from this requirement.

The tax rules for foreign earned income also benefit banks. These rules make certain foreign loans more attractive than U.S. loans. And they operate to reduce the U.S. income tax burden on U.S. income.

Banks are exempt from the rules governing straddles.

Banks may immediately deduct their start-up cost for credit card operations, while other taxpayers must writeoff start-up costs over a five-year period.

I am not unmindful of the financial problems which confront many of our nation's thrift institutions. Those that are ailing should not be saddled with additional tax burdens. But that is not the issue. The fact is that the majority of our financial institutions are thriving. They are paying few taxes or none at all. Some are even getting tax refunds.

Mr. Chairman, the revenues lost to these special tax breaks do little or nothing to create jobs, improve productivity, or spur economic growth. But what these special tax breaks do accomplish is to further reduce the corporate taxes and to further shift the tax burden to individuals.

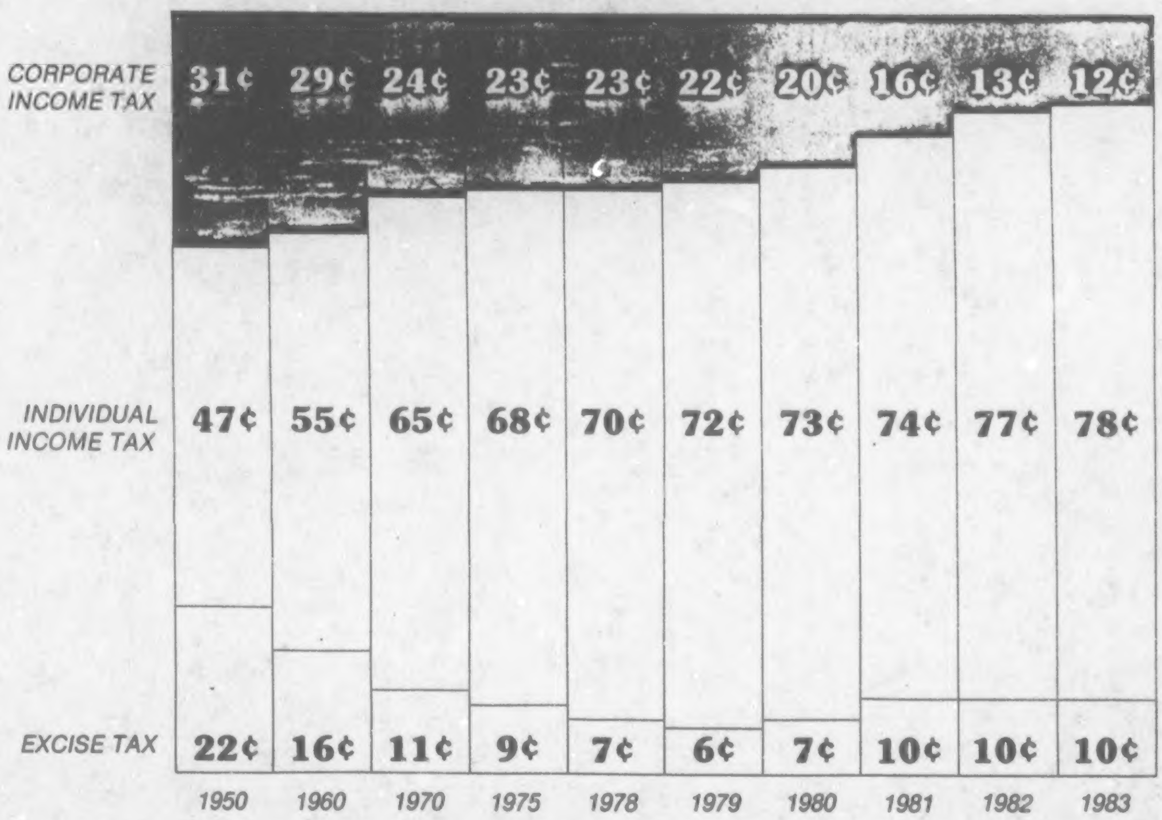
I urge this committee to repeal these unproductive tax breaks. In the interests of elementary fairness to the taxpayers of this country, I urge you to look at the low effective tax rates in other industries as well, and to take corrective action.

STATEMENT OF HON. HOWARD M. METZENBAUM, U.S. SENATOR FROM THE STATE OF OHIO

Senator Metzenbaum. Thank you, Mr. Chairman.

Mr. Chairman, I am deeply concerned about what is happening to our country's tax policy. We are facing record high budget deficits of $200 to $300 billion, yet this year we will collect 20 percent fewer dollars from corporate income taxes. And corporate income taxes as a share of GNP are expected to reach a post-World War II low of 1.3 percent.

What we see developing is an unfair sharing of the tax burden, pushing more and more on the individual taxpayer and less and less on the corporations of this country.



SOURCE OF FEDERAL REVENUE

This chart over here indicates it pretty clearly [indicating]. In 1950, corporate income taxes were 31 cents of the Federal tax dollar, excluding social security taxes. They have gone down to 12 cents. Individual income taxes in the same period went from 47 cents up to 78 cents, and excise taxes during that same period pretty much held their own. They didn't make that much relative difference.

But the disparity in the question of the tax burden between individuals and corporations has been almost unbelievable.

In industry after industry the pattern is clear. The Joint Tax Committee Study reports that in 1981 the paper and wood products industry had U.S. income of almost $1.4 billion; yet we see refunds or tax credits of $193 million. How do you explain that to the average working Joe who says, "They take a lot out of my payroll check each week, and yet they make $1.4 billion and get a tax refund of $193 million?"

Railroads made $1.7 billion, and received refunds and credits totalling $129 million. The top crude oil producers earned nearly $1 billion in income but paid only $31 million in taxes—a 3.1-percent effective tax rate. The chemical industry earned $3.1 billion but paid only 5 percent of that amount in taxes.

You have to say to yourself, "What kind of an America is this? Whose job is it to pay for the cost of government? Isn't there supposed to be some equity, some fairness, some equality?"

Last week General Electric reported that it earned $1.8 billion in 1982. And how much did it pay in taxes? It received a refund of $146 million.

Now, let me make something clear. I don't criticize the corporations of this country for that. It's not their fault. Neither you, Senator Long, nor Senator Metzenbaum, nor anybody is supposed to pay anything more in taxes than that which the law provides.

I was a businessperson before I came to the U.S. Senate, and I know that no good businessman will pay more in taxes than the law requires. It's not the fault of the corporate world; it's our fault; not theirs.

There is something wrong with our tax system when large profitable corporations don't pay a fair share of the tax burden. And it isn't they who are irresponsible for taking advantage of the tax deductions available to them, it is we in the Congress who are irresponsible as legislators if we fail to remedy this situation.

Now, I'm not alone in this belief. Corporate income taxes have been cut so much that 16 newly elected Republican Senators, that so-called group of conservatives who came in in 1980, last year wrote a letter to the President of the United States in which they said, "We are greatly concerned that by 1985 as many as one-half of all corporations may be paying no corporate income taxes."

The letter went on to say, "It would be a mistake to allow such a situation to develop at a time when all citizens should be asked to assume their fair share of that burden."

That wasn't a group of liberals; that wasn't a group of economists; that was a group of 16 conservative Republican Senators who themselves were so amazed at what we had done in the tax laws that they saw fit to write a letter to the President saying, "We didn't know that 50 percent of the corporations would be paying no taxes by 1985."

Mr. Chairman, the subject of this hearing today, the low effective tax rate of financial institutions, is an example of the problem we face.

I was in the banking business, and I'm aware of the tax advantages, but I think they are greater today than they were then. In 1981 this country's 20 largest banks earned $1.9 billion in U.S. income. Well, what did they pay in taxes? A paltry $53 million in taxes—a 2.7-percent tax rate.

You work in a steel mill, you work as an auto worker, you work as a waitress, you work anyplace, you pay a minimum of about 20 percent. Banks paid 2.7 percent.

Six banks had incomes ranging from $8 million to $154 million. How much did they pay in taxes? They paid no taxes, and either received a tax refund or credits to reduce future tax liabilities.

For example, the Nation's second largest bank, the Bank of America, had income of $154 million, but will either receive $18 million in refunds or reduce its future years' tax bills by that amount.

If we permit this kind of thing to continue, then we aren't the legislators that we ought to be.

Congress has enacted various provisions throughout the years that have gone just the opposite way: An artificial bad debt deduction. Every other business computes its bad debt deduction on the basis of what its bad debts actually were; but for banks we set up artificial figures. We give them foreign tax credits, net operating loss carryovers and other provisions that at the time we enacted them may have seemed to make sense. But in combination with one another these tax provisions are today operating to reduce and in many cases eliminate the legitimate tax liability of the Nation's largest banks.

Since 1951, for example, financial institutions have enjoyed this excess bad debt deduction that I mentioned. No other business has it. General Motors doesn't have it, General Electric doesn't have it, the oil companies don't have it—nobody has it. If other businesses have bad debts, they write off the actual amount. But under this special provision, banks and other financial institutions are permitted to compute and deduct amounts far in excess of their actual losses. Why? There isn't any reason on God's green Earth that explains why they've got this special privilege.

And what does it cost the Federal Treasury? I'm sitting over there in the Budget Committee that's meeting right now, and we're scrimping and trying to find a few bucks. We're taking food out of kids' mouths. But between now and the end of fiscal year 1981, the bank bad debt deduction will reduce Federal revenues by $4,200 million.

Now, last year's Senate Budget Committee Report on Tax Expenditures indicated that this artificial bad debt reserve, which is scheduled to expire in 1988, is a major reason why the banks pay such low effective tax rates. A year ago, however, the Treasury Department supported efforts to keep the deduction at its 1981 level permanently.

I don't understand the Treasury. And when I attempted to find out whether that was still the administration's position, the answer was "Maybe."

Last month when Treasury Secretary Regan testified before the Budget Committee I asked Mr. Regan if the administration would continue to favor retaining the bad debt reserve. His answer? "I do not know; we have not made up our mind on a position." Well, it's high time for the Treasury to make up its mind on such a matter. They make up their mind on everything that affects consumers and the people of this country and their taxes; but when it comes to the banks, Mr. Regan isn't quite sure what the answer is.

I must say that I find that amazing. This administration has no trouble concluding that we need more and more taxes on individuals, consumer taxes, $5 a barrel on oil, a standby tax of 12-cents-a-gallon, an income surcharge, taxes on unemployment compensation, new taxes on employer-provided health care, but the administration won't touch the banks.

The bad debt reserve is only one of a number of special tax breaks tailored for the banking industry. In 1969 when Congress decided to phase out the bad debt reserve through 1988, the industry, not without its own kind of ingenuity, obtained for itself a new loophole. What we took away with one hand we gave back with the other. Let me explain how that provision works:

All companies which accumulate more tax writeoffs than they can use in a given year may apply these tax breaks against taxes paid in the 3 previous years to obtain a tax refund. But banks? Oh, no. They are special. Banks can receive refunds for taxes paid during the previous 10 years. There isn't any reason under the Sun for that.

What rationale exists for this special treatment? I can only find one, and that is that there were some great industry lobbyists who decided if the banks were going to lose the artificial bad debt reserve they should get a new loophole to take its place, and they did.

Financial institutions enjoy even more special-interest tax breaks. The Tax Code says that taxpayers may not deduct interest on obligations used to finance the purchase of tax-exempt securities; but the tax laws exempt banks from that requirement.

The tax rules for foreign-earned income also benefit banks. These rules make certain foreign loans more attractive than U.S. loans, and they operate to reduce the U.S. income tax burden on U.S. income.

Banks are exempt from the rules governing straddles. Banks may immediately deduct their startup costs for credit card operations, while other taxpayers must write off startup costs over a 5-year period.

I am not unmindful of the financial problems which confront many of our Nation's thrift institutions, and I am concerned about those problems. Those institutions that are ailing should not be saddled with additional tax burdens. But that's not the issue.

The fact is that the majority of our financial institutions are thriving. They are paying few taxes or none at all. Some are even getting tax refunds.

Mr. Chairman, the revenues lost to these special tax breaks do little or nothing to create jobs, improve productivity, or spur economic growth.

Now, having said that, Mr. Chairman, let me address myself to the matter at hand. There is an issue on the floor of the Senate having to do with the question of withholding, and the media has spoken out on the subject over and over again, that your interest in this issue with respect to taxing the banks on a fair and equitable basis, or certainly a higher basis, relates directly to that.

Mr. Chairman, let me say that I don't wish to make a moral speech; but if this committee were to back off its interest in this subject by resolving the issue that sits on the floor at the moment, I would say it would affect our credibility as Members of the Congress.

I cannot say it to you strongly enough—and I address it particularly to you, Mr. Chairman. You have provided yeoman leadership; you have shown courage in the last session of the Congress in going back and undoing some of the wrongs with respect to some of the tax loopholes that exist. And I would hope that you will continue in that effort, because you probably more than any other Member of the U.S. Senate can have an impact upon what we are doing over in the Budget Committee.

Nobody suggests that taxes should be raised—nobody argues that—but I don't think anybody can justify some of the loopholes that exist in the laws today for banks and for so many other institutions that wind up paying no taxes or getting tax refunds.

I say to you, you and I are members of different parties, but I would help you in every way possible, not to raise taxes—that isn't the issue—but to close the loopholes that make it possible for some not to pay their fair share of the tax burden. Nobody should pay more than their fair share, but nobody should pay less, either.

I do hope that you will see fit to move strongly and rapidly in this direction, as you did in the past session.

The CHAIRMAN. Senator Metzenbaum, thank you very much. I want to not only assure you but assure others, there is no relationship between the amendment on the floor and these hearings. We are going to be having a series of hearings. We are starting with financial institutions; we are looking at life insurance companies, property and casualty companies, and others in an ongoing effort to review the Tax Code to make certain that we have a balanced system.

I am not certain whether more taxes should be imposed. But the perception, if you just look at statistics, it seems that at least we ought to take a look at many of the preferences of existing law.

Now, I hope I haven't intimidated any bankers—I don't think that would be helpful.

Senator METZENBAUM. You haven't done very well at it, if you have tried.

The CHAIRMAN. Right. [Laughter.]

But there is no relationship with what is taking place on the floor, except that it does interfere with this hearing.

But we will struggle through somehow, and we can always have another hearing.

But I appreciate very much your testimony, and I think we do have that responsibility. We are not trying to prejudge this matter or any other matter, but it does seem that one reason the bank can spend so much money is that they don't pay much tax. So they can send out a lot of mail and a lot of ads and do a lot of things that the normal corporation couldn't do. If you are only paying a 2-percent effective rate, you have a little more change in your pocket.

I have no questions. Senator Long may have questions.

Senator LONG. Mr. Chairman, if that withholding issue had nothing to do with this hearing, I would suggest that you see if you can get the Washington Post straightened out. [Laughter.]

Here is an article that appeared in yesterday's business page of the Post about the study it says was requested by the chairman of the committee, and it says something to suggest that this is an effort to try to make the banks quit advocating a repeal of the tax withholding on interest and dividends. The Washington Post admires the chairman just as I do, but I think they've got to get their reporters straightened out.

The CHAIRMAN. Well, I think it may have expedited the hearing a little, but I'm not certain.

Do you have any questions, Senator?

Senator LONG. Well, I just wanted to say one thing.

It seems to me that we ought to take into account the whole mix when you talk about people paying no taxes. You referred to the crude oil extraction industry paying 3.1 percent. In my State I know for a certainty that they pay a 10-percent severance tax—that's 10 percent of gross. You know, even if you make no profit at all you are still paying the 10 percent of the gross, not net. Then if that's a major company, we tax them 70 percent of everything over $14—the windfall profits tax—and the only deduction they get from that is taxes they've already paid. All the cost of refining the oil and producing it is not deductible under the windfall profits tax.

So you say they only are paying 3 percent. I'm not sure whether that's correct or not, but my impression is that they are paying low taxes because the Government got so much of what they had with taxes prior to that point.

Now, when we are talking about the taxes they pay, it's only fair that you consider all the taxes someone pays—particularly if you are talking about a gross income tax that they get him with before he knows whether he has a net profit or not.

Senator METZENBAUM. I'm sorry, I missed that.

Senator LONG. I say when you are talking about the taxes that somebody pays, you ought to consider all the taxes they have paid, especially when you are talking about a tax they put on someone's gross income, which hits him before he knows whether he has a net profit or not.

Senator METZENBAUM. Well, I understand that, Senator Long; but the fact is that everybody must pay a number of different taxes. Individuals pay other taxes as well. And what I am talking about, and I think this chart clearly indicates it is that when we are talking about income taxes, the share of the Federal revenues coming from corporate income taxes has greatly declined while the share of the total revenue from individuals has greatly increased. So when I am referring to the rates here, when I am talking about percentages, I am comparing equals with equals. I am comparing some segments of the economy with other segments of the economy; and I'm not talking about grosses, I am talking about taxes on income earned—not taxes on gross revenues.

Senator LONG. Well, Senator, when you put an across-the-board 10-percent or 20-percent tax that the producer cannot pass on, one that comes strictly out of his hide, then to say that that's not a tax on income, to me, is strictly a matter of splitting hairs, or a matter of semantics. It's a tax on his income whether he has a net income or not.

It doesn't do me much good for you to tax away what I'm making and then say, "Well, but you see, we call that by a different name. We call this a tax on net, and we call this a tax on gross."

If you are talking about what you are taxing away from me, and if you tax it all away by taxing my gross income before I pay that tax on net income, it's misleading to say I only pay the 3-percent tax on net if you taxed it all away to begin with.

Senator METZENBAUM. But what I'm saying is, here is the income, and here is the little amount that is paid in taxes. I am comparing the amount of tax paid on the actual corporate income. And I think that's the only means that you have with which to compare.

There's no sense in saying that a company does a hundred billion dollars' worth of business and only makes $3 billion. It may be that that company has a $2 billion net worth. Now, these are actually just fictitious figures, of course, but I think the real question is: On the $3 billion of income, how much tax do they pay? I think that is the real issue.

All I am saying is that on the income that is made they ought to pay a fair share. I like your phrase, I always remember it. I think it goes something like, "Don't tax him, don't tax me, tax the fellow behind the tree." I think it's something like that. And I am not saying that. I am just saying let's be fair. Let's have some balance. And what I am trying to address is the egregious cases where the taxation of certain segments of the economy is not fair compared to other segments.

Senator LONG. Well, what I'm trying to say, Senator, is that in your comparisons you mentioned the oil industry.

Senator METZENBAUM. No, I really didn't. I want to make that clear. I only talked about the crude oil producers, and that does not represent the crude oil refiners which have a much greater segment of the income, and the figure for that is a higher one than the one I used here. This came from the Joint Economic Tax Committee study.

Senator LONG. I noticed that.

Now, I have asked the executive officers of major companies this question. Out of the additional money they got because of the increase in the price of oil, how much of that did they have left that they could put back into oil production?

Generally their statement to me has been that they have about 16 cents left out of every dollar. In other words, the taxes going to government—Federal and State—plus the royalties, most of which are going to government, work out to about 84 cents on each dollar.

Those are taxes they can't pass along. We're not talking about taxes at the pump; we're talking about what they are paying in addition to that.

Now, this 3.1 percent you are quoting is only one of the taxes. And the reason that's so low is that taxes are taking so much of it before it ever gets down to a matter of net income.

Senator **METZENBAUM**. The thrust of my remarks, Senator Long, as I think you are aware, does not concern this company or that company; it's a question of our responsibility to see to it that the tax laws are fair and equitable. And in my opinion they are not now.

The main thrust of my comments had to do with the banks. I have referred to the oil industry, to the oil producers, as one of the groups; but I did not single them out today, and my feeling is that what this committee is doing is exploring all of the areas to see where certain segments of the economy get special tax breaks that the rest of industry doesn't get. And I think that's the real issue that your committee is faced with.

Mr. Chairman, I understand there is a hook that gets you after that red light goes on, and I don't want to be hooked.

Thank you very much.

The **CHAIRMAN**. I don't know if Senator Pryor or Senator Bradley had questions.

Senator **PRYOR**. No, I do not.

Senator **BRADLEY**. No, Mr. Chairman.

The **CHAIRMAN**. Thank you very much, Senator Metzenbaum, we appreciate it. Good luck in the Budget Committee.

Senator **METZENBAUM**. Thanks. I'll tell them how much X you're coming from. [Laughter.]

The **CHAIRMAN**. Don't tell them yet. The next witness is William S. McKee, Tax Legislative Counsel of the Treasury Department.

Before Mr. McKee starts, I would like to just summarize a statement that I have and then ask that it be made a part of the record.

Today's hearing is an initial effort, as I said earlier, to ask and hopefully to answer the question whether commercial banks, thrift institutions, and credit unions are bearing their fair share of the income tax burden. I frankly admit that I do not know whether the tax preferences and other tax provisions used by many of these financial institutions are unwarranted, inefficient, or too generous. This is why I am interested in hearing the testimony of our distinguished witnesses today.

But there are certain facts, and Senator Metzenbaum has alluded to some, they come from the same source. First, commercial banks enjoy an unusually low effective tax rate on their U.S. income. In 1981 a sample of 20 large commercial banks studied by the staff of the joint committee enjoyed an average effective tax rate of 2.3 percent. In contrast, the average effective tax rate for individuals was in the range of 20 percent, and many industries had effective tax rates higher than 30 or 40 percent.

In all fairness I should point out that many large corporations appear to enjoy effective tax rates lower than the statutory corporate tax rate of 46 percent, and I am not quite as concerned about that as Senator Metzenbaum is.

Second, financial institutions enjoy special tax preferences, and they have been touched upon in earlier testimony. Banks are generally permitted to deduct interest paid to carry tax-exempt securities, a privilege not enjoyed by other taxpayers. Savings and loans enjoy special loan-loss provisions, and credit unions enjoy complete exemption from Federal income taxation, regardless of whether their income is distributed as dividends. That means that a credit union is not only better off than a business corporation subject to the corporate income tax; credit unions are also better off than consumer cooperatives who can avoid income taxation only if they distribute all of their current income to their members.

While many credit unions are small, their ability to accumulate income free of tax has undoubtably contributed to their rapid growth.

In 1981, for example, the 10 largest credit unions each had assets greater than $200 million, and the 2 largest credit unions—the Navy Federal Credit Union and the Pentagon Federal Credit Union—had assets of $949 million and $554 million respectively.

I just suggest that we have a responsibility to determine whether or not the system is fair. Some around here are seeking to repeal the third year of the tax cut; some want to do away with indexing; the President wants to tax business more; and I think we have an obligation before we plunge into that area to see whether or not the present system is fair.

So I would just say that in conducting this review the answers are by no means preordained. It is clear that the ownership of tax-exempt bonds is a very significant factor contributing to the low tax rates of many commercial banks, but our committee may well decide that the preferences that give banks a special incentive to invest in tax-exempt bonds should be retained, despite the inefficiency and windfall for bondholders that have been associated with this method of assisting States and local governments.

On the other hand, a recent article in the Weekly Bond Buyer suggested that certain changes in the taxation of commercial banks such as enactment of a corporate surcharge similar to that proposed by President Reagan could improve the market for tax-exempt bonds by making them more attractive to the banks. I won't go into that analysis, but it's in my prepared statement.

Finally, perhaps the committee may want to review, after we have had not only this hearing but other hearings, whether income taxation is the best method of insuring that financial institutions pay their fair share of the Federal tax burden, especially when the Federal Government is called upon to bear the cost of certain governmental programs and activities of particular benefit to the financial industry.

In the recent postelection session of the 97th Congress the Surface Transportation Assistance Act of 1982 increased the user taxes on gasoline, certain tires, and certain trucks to contribute to the important national task of repairing our Nation's highways and bridges. It may be appropriate for the committee to review the possibility of imposing similar user taxes in addition to the income tax to support governmental programs of significance to the financial industry.

For example, Congress will soon be considering the administration's request to increase our quota authority for the International Monetary Fund by $8.5 billion. I do not believe that this proposal is a bailout for the banks, as some have suggested. By the same token, I do not believe that last December's highway repair bill was a bailout for the Nation's drivers, truckers, and other highway users. Perhaps it would be appropriate, however, to consider asking the Nation's commercial banks to pay a user tax, possibly an excise tax related to the size of their deposits, to contribute a greater share to the cost of participating in the International Monetary Fund. Although I am a strong supporter of our continued participation in the IMF, I was surprised to discover the relationship between the cost of our participation and the amount of taxes paid by commercial banks.

According to the Treasury Department, our participation in the IMF cost the Treasury an average of $107 million each year over the last 13 years; but in 1982 our participation cost $528 million, and in 1981 it cost $1.5 billion. These recent cost figures may be extraordinary and may not indicate a trend of growing costs, but it is noteworthy that our participation in the IMF in 1981 cost the Federal Government more than the entire amount of Federal income taxes paid by all commercial banks in 1980, the most recent year for which statistics are available.

So I think it is an area that we should address. I just suggest that for many reasons, before we start taking away the tax cuts that were enacted in 1981, or repealing indexing, or tightening up on ACRS anymore—I think we have done enough of that—we had better take a look for revenues in areas where we believe, at least on the surface, that there may not be a balance.

Again, I regret the error in the Washington Post, but I would suggest that there is no relationship between these hearings and withholding.

Mr. McKee.

STATEMENT OF WILLIAM S. McKEE, TAX LEGISLATIVE COUNSEL, DEPARTMENT OF THE TREASURY, WASHINGTON, D.C.

Mr. McKEE. Thank you, Mr. Chairman, and members of the committee.

I am pleased to have the opportunity to discuss the current rules governing the taxation of depository institutions. We think it is appropriate and timely to review the tax treatment of all financial institutions and their products, given the significant changes in the financial services industry in recent years.

By way of background, recent financial deregulation measures such as the Garn-St Germain Act have made the products of various financial institutions more similar, as well as the institutions themselves.

The tax treatment of these institutions can greatly affect their relative competitive positions.

In general, we believe that similar tax treatment is appropriate for similar products offered by similar institutions; and thus we believe it is especially timely at this moment to review the tax treatment of all financial institutions.

A review of the taxation of financial institutions is also important as we try to encourage long-term savings which flow primarily through these institutions. Tax rules affect these savings flows, and unjustified tax differences among institutions can reduce and distort these flows from their most productive uses.

We have not completed our review of the financial institutions' problems, but we are prepared to discuss some of the considerations which should be part of such a study.

First, I will turn to a description of the major relevant tax provisions which affect these institutions. Under current rules depository institutions are generally subject to the corporate tax. A major exception, however, is credit unions, which are totally tax-exempt. Needless to say, this has contributed to their rapid growth in recent years, as the chairman has pointed out.

There are two general rules which greatly affect the tax treatment of depository institutions that are also applicable to other taxpayers:

First, and perhaps most important, is that the interest on State and local bonds and on industrial development bonds is tax free. Banks are primary investors in such bonds.

Second, the investment tax credit and the benefits of the accelerated cost recovery system are available to lessors of equipment, and banks are significant lessors.

There are also some special provisions which apply to depository institutions. As previously noted, the most important perhaps is that interest paid or accrued to purchase or carry tax-exempt obligations is deductible by financial institutions. Other taxpayers cannot deduct such interest. Under the 1982 Tax Act, this benefit was reduced somewhat by disallowing 15 percent of such interest as a deduction. Nevertheless, it is still a major tax benefit to depository institutions.

Third, there are special rules dealing with additions to bad debt reserves of financial institutions. These depository institutions can use a method of calculating their bad debt reserves which is totally unrelated to the actual experience of such institutions. Banks can choose either the percentage or the experience method on an annual basis. Under the percentage method they are entitled to maintain a bad-debt-reserve equal to six-tenths of 1 percent of loans outstanding.

Thrift institutions can also use an additional method, which is the percentage-of-taxable-income method, if they hold a sufficient volume of residential mortgages. Under this method a thrift institution is entitled to a deduction of 40 percent of its taxable income. This reduces the maximum rate applicable to such institutions to 27.4 percent, since only 60 percent of its taxable income is subject to tax at the maximum Federal rate of 46 percent.

There are various other special rules applicable to financial institutions which have been mentioned, such as special net-operating-loss rules, special rules dealing with mutual thrift institutions, and special rules dealing with the reorganizations of financially troubled thrift institutions.

There are also some special tax rules that are applicable to the products produced by these financial institutions. Most of these special rules reflect conscious policy decisions on the part of the

Congress, such as the provisions dealing with IRA's and qualified pension and profit-sharing plans. There is one aspect of those rules, however, which probably does not reflect a conscious policy decision, and that is that the income from services which are coupled with an investment by a depositor escapes tax altogether.

For example, the value of the free checking account which you get from your bank is totally tax free. Your bargain with the bank, of course, is to give them your money in exchange for a low rate of interest—they don't pay a very large rate of interest on the initial amount that you put in—plus you get free checking. Obviously the free checking is a substitute for interest which would otherwise be taxable. This is a significant benefit to institutions which can take advantage of this rule.

Turning now to the effective tax rates on financial institutions: The studies have shown that effective tax rates on commercial banks are among the lowest among all industries.

The conventional measure of a taxpayer's effective tax rate is a simple ratio of the taxes paid by the taxpayer—or the industry—divided by the financial statement income of that taxpayer—or that industry. Such a measure shows the extent to which the tax system is used to provide incentives for numerous social purposes rather than raise revenues at the statutory rate. With the current budget deficits, we should carefully review the Tax Code and all of its provisions to insure that the purposes behind these tax incentives are still valid.

Under conventional analysis, the 20 largest banks pay only a 2.7-percent effective tax rate. This shows primarily that a large amount of tax subsidy is passing through the commercial banking sector. Some of these tax subsidy provisions are targeted specifically to banks and thrift institutions; for example, the tax exemption for credit unions, the fact that thrifts are entitled to calculate their bad-debt deduction using the percentage-of-income method, and the fact that banks are entitled to deduct interest paid to purchase or carry tax-exempt securities.

Other rules that produce this low effective rate are generally applicable to all taxpayers—primarily, the fact that interest on State and local bonds and private purpose industrial development bonds is tax free.

In looking at these benefits it is important to see which ones accrue primarily to the banks and thrifts—the bad-debt deduction provision, for example—and which ones are wholly or partially passed through to the intended beneficiary of the subsidy. To the extent that the tax benefit is passed through to someone else, the banks suffer an indirect burden imposed by the tax system. From the point of view of the bank shareholders, the indirect burden with respect to State and local bonds is the fact that the bank receives a lower interest rate than it would receive on fully taxable bonds. Similarly, with respect to leased property, the bank receives less rent than it otherwise would receive. Thus, from the bank shareholder's point of view, the tax system imposes an indirect burden on the banks.

For our analysis of the effective tax rates of banks, therefore, a critical issue is how efficient the passthrough is. How much of the subsidy in these situations is going to the intended beneficiary, and how much is siphoned off by the banks in the process of delivering the subsidy?

In the short-term, tax-exempt market, for example, the pass-through is generally fairly efficient; although, depending upon market conditions, it can be more or less so. The banks in general keep only a small amount of the subsidy inherent in the tax exemption in the short end of the market.

In long-term tax exempts, however, banks capture between one-third to one-half of the subsidy inherent in the tax-exempt bonds. In other words, at the long end of the tax-exempt bond market we have a very inefficient subsidy delivery vehicle, and the banks are primary players in that end of the market.

We therefore think that it would be appropriate to explore an alternative calculation of effective tax rates. Under this method, we would attempt to remove the subsidy element that passes through to the bond issuers or to the lessees, and attempt to focus only on the subsidies that are actually captured by the banks or the other financial institutions. Such a measure would show an effective tax rate figure that would be larger than the 2.7-percent figure under the conventional analysis, but still would be substantially less than the 46-percent statutory rate.

In fact, we expect that bank shareholders are probably not capturing a great deal more tax benefits than other sectors of the economy. Nevertheless, that doesn't mean we shouldn't be extremely concerned about what is going on. The effective tax rate analysis once again shows that an enormous amount of subsidies are passing through the system. We can also tell from examining the banks that the method of delivering those subsidies is often inefficient.

For example, we question whether the revenue drain occasioned by private-purpose industrial development bonds is appropriate. And we note that in this area banks tend to capture a significant portion of the subsidy targeted to private individuals in exchange for delivering the subsidy, because private-purpose IDB's tend to be concentrated to some extent in the long end of the market.

I must point out, however, that a conventional effective rate analysis does ignore the indirect burden borne by the banks through lower interest yields on tax-exempt bonds and lower rents on leased property, and thus is somewhat misleading in assessing the amount of this tax subsidy that accrues to the banks as opposed to other industries, and is not a precise enough measure of analyzing how much of the subsidy sticks with the banks and how much of the subsidy passes through to the intended beneficiary.

In conclusion, it is our view that the relative tax treatment of financial institutions and products has assumed increasing importance as financial deregulation makes these institutions more alike.

The issues raised in these hearings deserve careful analysis and consideration, and we would like to work closely with the tax-writing committees on a comprehensive review of all financial institutions and their products and a review of the existing subsidies provided through the tax system.

That concludes my remarks.

[Mr. McKee's prepared statement follows:]

For Release Upon Delivery
Expected at 10:00 a.m. EST
March 11, 1983

STATEMENT OF
WILLIAM S. MCKEE
TAX LEGISLATIVE COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Committee:

I am pleased to have this opportunity to discuss the current rules governing the taxation of depository institutions. We think it is appropriate and timely to review the tax treatment of all financial institutions and their products given the significant changes in the financial services industry in recent years.

Background

Any tax legislation affecting depository institutions and their products should reflect the significant changes that have occurred recently in the operation of all financial institutions. Financial deregulation measures, such as the Garn-St. Germain Depository Institutions Act of 1982, have expanded the powers of banks and thrift institutions. In addition, the life insurance industry has developed new products that contain predominantly investment features similar to those offered by depository institutions. As a consequence of the increasing similarity of products offered by different financial institutions, the tax treatment of the institutions and their products can greatly influence their relative competitive positions.

The taxation of financial institutions is also particularly important as we pursue our commitment to encouraging long-term savings which are essential to the continuation of our economic recovery. The rate of return to savers and the relative efficiency of the use of the savings are affected by the taxation of the financial institutions through which a major portion of all savings flow. Different tax rules for financial institutions and their products may also reduce and distort the flow of savings from their most productive uses.

While we have not completed our review of the tax treatment of depository institutions and other financial institutions and their products, we are prepared to discuss some of the general considerations which should be part of such a study. First, I will briefly describe the major provisions of current law affecting the tax treatment of depository institutions and their products.

Current Tax Rules Affecting Depository Institutions and Their Products

General

Depository institutions generally are subject to the corporate income tax. Credit unions are an exception and are exempt from tax on their income, regardless of whether retained or distributed to depositors as dividends. When savings and loan associations and mutual (nonstock) savings banks became subject to the corporate income tax in 1951, credit unions were not made taxable despite their similarity to other thrift institutions. However, in 1951 credit union deposits represented a relatively small share of total savings. Since that time, credit unions have grown rapidly, partly as a result of their tax-exempt status.

Significant General Tax Rules

Before describing the special tax rules applicable only to depository institutions, I should make note of two aspects of the Internal Revenue Code which are not limited to depository institutions but which significantly affect the tax liabilities paid by depository institutions. It is important to understand that these two provisions are available to all taxpayers.

First, the interest on State and local government obligations (including certain industrial development bonds issued for private businesses) is exempt from tax. Close to half of the new tax-exempt bond issues in 1982 were for private purposes, such as owner-occupied housing, pollution control, student loans, private hospitals, and private businesses. Commercial banks are among the primary investors in tax-exempt bonds. Second, the investment tax credit and accelerated cost recovery ("ACRS") allowances reduce the tax liabilities of depository institutions as a result of their participation as lessors in leasing arrangements.

Special Rules for Depository Institutions

Deduction for Interest Paid. Financial institutions differ from nonfinancial businesses in their heavy reliance on debt capital. Most of the funds employed by financial institutions are provided by creditors (depositors or policyholders), rather than by shareholders. The amount of equity capital as a fraction of total assets in most financial institutions is only 5-10 percent, compared to 40-60 percent for most nonfinancial businesses. Thus, the most important deduction is for interest paid (and, in the case of thrift institutions, dividends paid or credited on withdrawable accounts), which accounts for 60-65 percent of total expenses.

Generally, interest deductions are not allowed for debt attributable to purchasing or carrying tax-exempt securities. Prior to the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the interest paid by commercial banks to depositors was specially treated in that it was generally not considered to be incurred to purchase tax-exempt bonds. As part of a general cutback on corporate tax preference items, TEFRA disallowed 15 percent of the interest deduction on indebtedness incurred by commercial banks to purchase or carry tax-exempt obligations acquired after 1982. Other businesses, such as security dealers, whose businesses involve carrying tax-exempt obligations cannot deduct any interest paid to purchase or carry those bonds.

Deduction for Additions to Bad Debt Reserves. Unlike nonfinancial businesses, depository institutions can deduct additions to reserves for bad debts using a method totally unrelated to the actual experience of the taxpayer.

Commercial banks can choose either the percentage or the experience method for determining their bad debt deduction. The percentage method allows a current deduction for additions to reserves sufficient to maintain a reserve of up to 0.6 percent of eligible loans outstanding. The experience method generally is based on average loan losses over a six-year period. Banks need not use one or the other method consistently. The election to use the percentage method is scheduled to expire at the end of 1987, at which time all commercial banks must use the experience method.

Thrift institutions may use modified versions of the percentage method or the experience method available to banks. Alternatively, thrift institutions, if they hold sufficient amounts of their assets in certain eligible investments (primarily residential mortgages), can elect the percentage of taxable income method for purposes of establishing their bad debt reserves for qualifying real property loans. Savings and loan associations and stock savings banks must hold at least 82 percent of their total assets in eligible investments to be able to claim the maximum deduction, which is equal to 40 percent of taxable income (computed with certain modifications). The deductible percentage of taxable income is reduced if fewer than 82 percent of total assets are eligible investments. Mutual savings banks must hold at least 72 percent of their total assets in eligible investments to take advantage of the maximum deduction, which is also subject to reduction if the percentage of eligible investments declines below 72 percent. As a result of the deduction allowed under the percentage of taxable income method, thrift institutions that can claim the maximum deduction are subject to a maximum marginal tax rate of only 27.4 percent, since they pay tax on only 60 percent of their taxable income at a maximum rate of 46 percent.

Thrift institutions that qualify for the percentage of taxable income deduction are limited in the amounts of certain other tax benefits they may claim. For example, thrifts are entitled to only half of the otherwise allowable investment tax credit, and they receive a scaled back dividends received deduction compared to that available to other corporations.

The minimum tax provisions of TEFRA include a cutback of the amount of bad debt reserve deductions of depository institutions. Fifteen percent of the addition to bad debt reserves in excess of those allowable on the basis of actual experience is disallowed. Additionally, 71.6 percent of the the addition to bad debt reserves in excess of the the addition that would have been allowed based on actual experience is a tax preference item for purposes of the corporate add-on minimum tax.

The appropriate tax treatment for additions to reserves for future contingencies such as bad debts is an important issue in the tax treatment of financial institutions. In order to be neutral, the use of reserve accounting for tax purposes should be equivalent to the deduction of actual losses when they occur. The current deduction for additions to reserves by depository institutions and insurance companies may overstate the present value of the future expected losses and thus understate real income.

Other Special Provisions for Depository Institutions. A number of other special provisions in present law apply to depository institutions. Unlike most other taxpayers who are permitted to carry back net operating losses for only three years, commercial banks and thrift institutions are allowed a 10-year net operating loss carryback period (but are limited to a 5-year carryforward period rather than the 15 years generally allowable). This means that depository institutions may be able to claim refunds resulting from losses sooner than other taxpayers.

Mutual thrift institutions are allowed to deduct the full amount of interest or dividends paid or credited to withdrawable accounts, even though some of the dividends or interest may be paid to depositors out of a return on equity capital in their capacity as owners of the mutual institution. The return paid on equity generally is not deductible under our corporate tax system.

In addition, a series of special rules has been enacted to relieve tax liabilities or other burdens that would otherwise be imposed in case of mergers involving financially troubled thrift institutions.

The Tax Treatment of Depository Institution Products. The effect of the tax system on depository institutions is also determined by the income tax treatment of their products. The income credited on investments in bank and thrift deposits is generally subject to tax when earned, unless it is exempted for certain well-defined policy reasons. For example, the investment income earned on tax deductible contributions to qualified retirement plans and individual retirement accounts is effectively untaxed in order to encourage savings for retirement. It should be noted that these tax-favored forms of savings are available from all financial institutions. The All-Savers Certificate, which expired at the end of 1982, was an exception in that it was available only from depository institutions.

The income from investments which are offered jointly with financial services, such as checking account services, is often reported net of the income attributable to the value of the services. This is comparable to the deduction of the payment of the cost of those services. When financial services are unrelated to earning investment income, the costs of those services are similar to personal expenditures which would normally not be deductible. Thus, where investment income is reported net of the cost of personal expenses, nondeductible personal expenses are effectively converted to deductible expenses. Financial institutions that can offer tax-favored checking accounts and other personal services with their investment products can offer higher after-tax total returns and thus can attract more savings than other financial institutions.

Effective Tax Rates on Financial Institutions

Several studies have been published that show effective tax rates on commercial banks to be among the lowest for all industries. As conventionally measured, effective tax rates generally compare a taxpayer's taxes paid with its income reported on its financial statements for a given year. These measures indicate the extent to which the tax system is used to provide incentives for numerous social purposes, rather than to raise revenue at the statutory rates. At a time of fiscal austerity and large projected future deficits, the benefits from tax credits, deductions, and exemptions that cause low effective tax rates should be carefully reviewed to insure that the original purpose still merits this form of government assistance.

Conventional effective tax rates are significantly below the maximum statutory corporate tax rate in almost all industries. The Joint Tax Committee study, prepared for Representatives Pease and Dorgan, shows a ratio of U.S. taxes paid to current U.S. source income of 2.7 percent in 1981 for 20 large commercial banks. This indicates that a large amount of tax subsidies for a variety of purposes are passing through the commercial banking sector.

As previously explained, certain tax law provisions of general applicability to all taxpayers are heavily used by depository institutions to reduce their tax liabilities. In addition, there are other provisions that are peculiarly applicable to banks and thrifts. In the case of thrift institutions, examples of the latter provisions include both the tax exemption of credit unions, which reduces their effective tax rate to zero, and the percentage of taxable income bad debt reserve deduction, which reduces the maximum effective (and marginal) tax rate of other thrift institutions to 27.4 percent. In the case of banks, interest paid to depositors is deductible even though the borrowed funds are used to carry tax-exempt bonds which can reduce a bank's effective rate substantially below 46 percent. In addition, deductions for additions to bad debt reserves are available in amounts that may exceed bad debt losses determined on the basis of actual experience or expected future liabilities.

Some of the benefits of these special tax rules, such as the bad debt deduction allowable to banks, may inure primarily to the benefit of the financial institutions. Other benefits are shared with or transferred to others, such as State and local governments and IDB users that benefit from lower interest rates on tax-exempt bonds held by banks.

As I have mentioned, conventional effective tax rates can show the total amount of tax subsidy as compared to statutory tax rates. However, comparisons of those effective rates across industries cannot, in many cases, indicate which industries bear a lower direct economic burden from the tax system than others. The direct economic burden borne by taxpayers as a result of the income tax system cannot be measured simply by measuring taxes actually paid. This is because the tax system causes reductions in disposable income and creates differences between pre-tax and after-tax returns by means other than the direct assessment of taxes.

It is important in the case of banks to recognize that tax rules directly reduce the yields on tax-exempt bonds and the rentals on leased property. These market adjustments are what provide the subsidy to users of tax-exempt bond proceeds and lessees. For example, the tax exemption of interest paid on State and local government obligations increases the demand for them, which raises their purchase price and lowers the market yield below yields on comparable taxable securities. The lower yield on tax-exempt bonds accrues to State and local governments and IDB users in the form of lower interest costs, but that lower yield reduces the benefit of tax exemption from the point of view of bank shareholders. Thus, the low tax rate of investors in tax-exempt securities is a result of tax subsidies that accrue largely, but not entirely, to tax-exempt issuers.

If the pass-through of the subsidy is relatively efficient then most of the tax benefits will accrue to the intended beneficiaries. In the case of short-term tax-exempt bonds, the subsidy mechanism is usually fairly efficient. The percentage reduction in yield (and rate of subsidy) for most short-term tax exempts is reasonably close to the maximum statutory corporate tax rate of 46 percent plus the applicable net marginal State tax rate, so State and local government issuers receive most of the subsidy. In these circumstances, banks receive little more than the cost of the services provided. Tax-exempt bonds with longer maturities offer a lower rate of subsidy to tax-exempt issuers, since their yields range from 60 to 85 percent of taxable yields of comparable securities. Long-term tax-exempt bonds are thus quite inefficient subsidy mechanisms because the intended beneficiaries receive only between one-half to three-quarters of the lost Federal revenue, with the remaining subsidy captured by investors. The inherent inefficiency of the tax-exempt market and the concomitant benefits received by banks could be eliminated by providing the subsidy to State and local governments and IDB issuers directly in the form of cash grants.

An alternative calculation of effective tax rates for banks could be attempted that would remove the subsidy element that benefits tax-exempt bond issuers and lessees and would only include the subsidy that benefits banks. Such a measure would show the differences in the cost of raising equity capital for banks as compared with such costs for other kinds of businesses. This measure of the effective tax rate would recognize the pass-through of tax benefits which typically occurs when the ultimate beneficiary pays a lower return to the financial institution because of the tax benefits. This measure of the relative tax burden across industries would restore the amount of benefits transferred to the ultimate beneficiaries to both the numerator and the denominator of the effective tax rate fraction.

The necessary adjustments in the computation of the effective tax rates of the largest commercial banks would clearly raise their effective tax rates significantly above the estimates given by conventional ratios of tax payments to book income, but they would remain well below the statutory tax rate of 46 percent. The alternative measure of the effective tax rate removes the subsidies that do not accrue to banks and focuses on the tax subsidy that banks actually receive.

Because of their major role as a tax intermediary, we would expect an alternative effective tax rate calculation to show that shareholders of commercial banks do not derive significantly more tax benefits than shareholders of other industries. Tax incentives that are available to all taxpayers should tend to equalize the cost of raising equity capital across industries. Only where the tax benefits are limited to a particular industry, such as the banks' preferential interest deductions, the thrifts' special bad debt deductions or the credit unions' tax-exempt status, would relative tax burdens be expected to vary greatly.

Even though an alternative effective tax rate analysis would probably show that banks are not capturing more tax benefits than other sectors of the economy, it must be remembered that large amounts of tax subsidies are being passed through banks to other beneficiaries. Clearly, this large leakage of revenue is a cause for concern if the subsidies are inefficiently delivered through the banks or the subsidies are benefiting activities that do not merit government assistance.

In summary, two points must be kept in mind. First, there are large amounts of subsidies that are currently being delivered through the tax system. The low conventional effective tax rate paid by large banks raises the question of the propriety of such large subsidies hidden in the tax system. For example, we question whether the large volume of private purpose IDB's, which account for roughly half of new tax-exempt bond issues, should continue to be a drain on Federal tax revenue and reduce the taxes paid by investors in tax-exempt bonds, such as commercial banks.

Second, conventional effective tax rates do not show who actually benefits from the subsidies. An alternative calculation is needed to compare the relative burden of the tax system across industries, because many of the tax benefits are passed through to nontaxpayers.

Tax Incentives and the Minimum Tax

One response to low effective tax rates has been an expansion of the minimum tax provisions. It must be recognized that, in most instances, the minimum tax reduces the extent to which taxpayers make use of the existing tax incentives. This reduces the amount of the subsidized activity or the amount of the subsidy received by the intended beneficiaries. Thus, a minimum tax must balance the concern with fairness and the desired amount of the tax incentives.

This tradeoff can be seen in the case of the tax preference cutback on banks' interest deductions for holding tax-exempt bonds. The effect of the cutback on the interest deduction incurred for carrying tax exempts will initially reduce banks' demand for tax-exempt bonds. This will reduce the Federal subsidy inherent in tax-exempt financing by raising the interest rate that eligible borrowers have to pay to a rate closer to that paid by all other borrowers.

A comparison of the two changes in TEFRA affecting tax-exempt bonds is instructive. The tax preference cutback provision indirectly reduced the incentive provided to issuers of tax-exempt bonds by reducing the interest deductions allowed commercial banks. TEFRA also included a number of direct limitations on the use of tax-exempt bonds for private purposes. The limitations on industrial development bonds included reducing the double-dipping of tax benefits by private users of tax-exempt bond proceeds and requiring public approval of the bond issues to insure that they serve a public purpose. The bank preference cutback reduces the subsidy to all tax-exempt bond issuers, while the IDB restrictions are targeted at private purpose tax-exempt bonds and would actually improve the rate of subsidy for the remaining State and local public purpose issuers.

Conclusion

The relative tax treatment of financial institutions and their products will become increasingly important as financial deregulation and other developments make these different institutions more alike in the financial services they provide. The issues raised in these hearings deserve careful analysis and consideration. The Department of the Treasury would like to work closely with the tax-writing committees on a comprehensive review of the tax treatment of all financial institutions and their products, and a review of the existing subsidies provided through the tax system.

Senator CHAFEE. Senator Long.

Senator LONG. Are you up here to recommend an increase in taxes on the banks?

Mr. MCKEE. Senator, we are recommending that we work with the committees to analyze the taxation of all financial institutions.

Financial institutions, as tax intermediaries, play an important role in delivering tax subsidies through the system. We think it is very important to analyze those tax subsidies, analyze the way in which they are being distributed through the system.

We are not at this time prepared to make any specific recommendations other than to say we think the matter is of serious concern and deserves careful study.

Senator LONG. During the consideration of the 1981 tax-cut bill, the Secretary of the Treasury, speaking for your Department, suggested that we continue a tax break with regard to the matter of reserves that banks can deduct, which amounted to continuing a tax break that banks have, whether it is justified or not.

Why did the Treasury recommend that further tax break for the banks if it didn't think they are paying enough taxes?

Mr. MCKEE. Again, Senator, I am not in a position to go back and analyze the statements of the Secretary of the Treasury. As the tax legislative counsel, that's obviously not my role. I will point out that, again, that we do believe there are problems in the taxation of banks along with other financial intermediaries. Many financial intermediaries have special treatment dealing with reserves, deductions today for losses that won't occur in the future, which is an anomaly in the Federal tax system, and we think it deserves careful study.

Senator LONG. Well, I can't help but be impressed by the fact that as recently as 1981 the Treasury was recommending a further tax cut for the banks, at a time when the banks were supporting the position that Treasury was taking on that bill, and now you come along a year or so later and you want to look into putting more taxes on them. It has been alleged by the newspapers—and I suspect there is some evidence to support it—that this has to do with the fact that the banks are not in favor of the withholding provision on interest and dividends, which mainly affects their customers.

Senator LONG. Now, this change of position is somewhat hard for some of us to understand. For example, here is a resolution that I reported on behalf of the Finance Committee—it wasn't my resolution—Senate Concurrent Resolution 92, that was reported in the 96th Congress. That was only a few years ago. And who was sponsoring that?

By the way, that resolution said that "it is the sense of Congress that the enactment of a withholding tax on interest and dividends payments would be detrimental to the well-being of the United States."

[The resolution follows:]

III

Calendar No. 948

96TH CONGRESS
2D SESSION

S. CON. RES. 92

[Report No. 96–863]

Declaring that the Congress does not favor the withholding of income tax on interest and dividend payments.

IN THE SENATE OF THE UNITED STATES

MAY 6 (legislative day, JANUARY 3), 1980

Mr. CHAFEE (for himself, Mr. DOLE, Mr. LUGAR, Mr. GOLDWATER, Mr. DECONCINI, Mr. HATCH, Mr. DURKIN, Mrs. KASSEBAUM, Mr. STAFFORD, Mr. TOWER, Mr. HUMPHREY, Mr. MCCLURE, Mr. COCHRAN, Mr. CHURCH, Mr. HELMS, Mr. PRESSLER, Mr. FORD, Mr. GARN, Mr. RANDOLPH, Mr. DANFORTH, Mr. HAYAKAWA, Mr. THURMOND, Mr. PRYOR, Mr. ZORINSKY, Mr. HATFIELD, Mr. MATHIAS, Mr. WALLOP, Mr. YOUNG, Mr. SCHMITT, Mr. COHEN, Mr. HEINZ, Mr. ROTH, Mr. LAXALT, Mr. DURENBERGER, Mr. BAKER, Mr. STEVENS, Mr. WARNER, Mr. ARMSTRONG, Mr. STONE, Mr. PERCY, Mr. GLENN, Mr. LEAHY, Mr. MORGAN, Mr. NUNN, Mr. BUMPERS, Mr. MCGOVERN, Mr. TSONGAS, Mr. SCHWEIKER, Mr. HART, Mr. EAGLETON, Mr. BOREN, Mr. METZENBAUM, Mr. MELCHER, Mr. STEWART, Mr. WILLIAMS, Mr. LEVIN, Mr. GRAVEL, Mr. NELSON, Mr. RIEGLE, and Mr. BENTSEN) submitted the following concurrent resolution; which was referred to the Committee on Finance

JULY 23 (legislative day, JUNE 12), 1980

Reported by Mr. LONG, without amendment

CONCURRENT RESOLUTION

Declaring that the Congress does not favor the withholding of income tax on interest and dividend payments.

Resolved by the Senate (the House of Representatives concurring), That it is the sense of the Congress that the enactment of a withholding tax on interest and dividend payments would be detrimental to the economic well-being of the United States.

Senator LONG. Now, who was sponsoring that? The principal sponsor was Senator Chafee, for himself, and Senators Dole, Lugar, Goldwater, DeConcini, Hatch, Durkin, Kassebaum, Stafford, Tower, Humphrey, McClure, Cochran, Church, Helms, Pressler, Ford, Garn, Randolph, Danforth, Hayakawa, Thurmond, Pryor, Zorinsky, Hatfield, Mathias, Wallop, Young, Schmitt, Cohen, Heinz, Roth, Laxalt, Durenberger, Baker, Stevens, Warner, Armstrong, Stone, Percy, Glenn, Leahy, Morgan, Nunn, Bumpers, McGovern, Tsongas, Schweiker, Hart, Eagleton, Boren, Metzenbaum, Melcher, Stewart, Williams, Levin, Gravel, Nelson, Riegle, and Bentsen.

I reported that. How could I do anything but report it? The majority of the committee were sponsors of the resolution. [Laughter.]

And may I say about this matter, I think I can see both sides of the argument. I have voted on both sides of this question. [Laughter.]

So I can see it from both points of view.

But can you honestly sit there and tell me that this doesn't have anything to do with the fact that there is a provision pending right now on the Senate floor to repeal withholding on interest and dividends? Can you, honestly? If you had to be under oath, could you actually make that statement? [Laughter.]

Mr. MCKEE. I can honestly say, Senator, that the Treasury Department has been engaged in the study of the taxation of financial intermediaries for about a year now, and that we do think the issue is worthy of careful analysis.

Senator LONG. About a year? Did that happen at about the time the banks started their campaign against withholding on interest and dividends?

Mr. MCKEE. Actually, Senator, it occurred when another group of financial institutions was discussing their tax treatment with us, and it kind of led to a broader inquiry.

Senator LONG. Insurance companies?

Mr. MCKEE. Well, it might have something to do with that.

Senator LONG. Because don't they get some of the same considerations?

Mr. MCKEE. Well, certainly the issue of reserves is one. Quite seriously, the Treasury Department is quite disturbed about the current deduction for expenses which will not arise until some future point in time, primarily because even though the expense occurs in the future it is deducted in terms of today's dollars, when the present value of that expense—which doesn't occur sometimes for 10 or 20 or 30 years—is obviously much smaller than that. And so we have grave concerns in terms of the tax system in general about the timing issues, about when you deduct a dollar when the dollar will not be paid until some future point in time. And the tax treatment of all financial institutions raises that issue across-the-board, and we are taking a very hard look at it. It is troublesome.

Senator LONG. Now, can you tell me how the taxation of banks compares to that of insurance companies?

Mr. MCKEE. We cannot at this time. We are not that far along.

Senator LONG. Well, don't you think you ought to be looking into that matter?

Mr. MCKEE. Yes, we definitely agree with you.

Senator LONG. Isn't that a big industry?

Mr. McKee. Well, both industries are very large industries.

Senator Long. Well, thank you very much.

The Chairman. I would just follow on with this. We took a look at life insurance companies last year, and I think over the 3-year period they are going to increase their tax burden by about $7 billion. So they cooperated with the committee. I think our estimates may be a little low, as I understand now.

But again it would be probably pretty hard to separate this from what is going on on the floor. It just all happened to fit together so nicely. How did I know Kasten was going to offer the amendment yesterday? I mean, he focused on withholding rather than the jobs bill, so the unemployed people are waiting while we massage the bankers. So it just seems to me that we will try to work it out the best we can. And this won't be the last hearing, I'm sure.

Senator Long, we are taking a look, as he suggests, and this has been in the works a long time—you can probably almost pinpoint the date since you have been looking at financial institutions. So there is no direct relationship between the avalanche of mail and this hearing, except I may have expedited it a little bit. If I can't answer the mail, I figured I might as well be doing something else. [Laughter.]

So what do you think about the tax exemption for credit unions?

Mr. McKee. Mr. Chairman, we can think of no sound tax policy reason for credit unions to be tax exempt.

The Chairman. You know, I can see a reason in the early stages, but as I recited in my testimony, there are a couple that are almost billion-dollar credit unions. Are you in the process of studying credit unions as well as S&L's and banks?

Mr. McKee. Certainly; again, Senator, we are very concerned about having equal tax treatment across all financial intermediaries that are essentially engaged in providing the same services. The fact that one group is tax-exempt and another similar group is fully taxable raises serious policy considerations.

The Chairman. All right.

Now, I assume you have got ongoing studies not just here but in a number of areas on whether or not it is a balanced system.

Mr. McKee. That is correct.

The Chairman. And as I have indicated earlier, we plan to have additional hearings. Again, we are not on a witch hunt; but it seems to me we have an obligation. We are getting all this talk about some trigger tax in 1986, 1987, 1988, to raise a hundred and some billion dollars; some want to repeal indexing; some want to repeal the third year of the tax cut; but it would seem to me that before we take away the tax cuts from individuals we ought to be taking a look at the entire system.

We've got about $296 billion in tax expenditures, and maybe there are areas that we can address. And I think there are a couple of questions we ought to ask just for the record:

Do you favor using the bad-debt deduction or other tax provisions to encourage mortgage lending?

Mr. McKee. In general, Senator, again, with the financial deregulation measures that have occurred in the last several years, we think that it is time to reexamine the reason for having, for example, the percentage of income bad-debt deduction used by thrifts as a way to encourage them into the home mortgage market.

The fact that the thrifts got caught in recent years with too large a volume of home mortgages and were unable to handle a period of rising interest rates suggests that the policy behind locking them into a large volume of home mortgages purely because of their tax position was not necessarily sound. And so we think it is time to relook at that again, especially in light of the fact that the recent very good efforts made on the part of the Congress to deregulate financial institutions generally has made many of these thrifts almost indistinguishable from banks, and yet they have very different tax treatment.

From an historical perspective one can understand perhaps why those rules were different when the institutions were so different; but now that the institutions are quite similar, we think that we ought to completely reexamine all the rules to try to get the tax rules to be the same.

The CHAIRMAN. Well, what are the factors that make tax-exempt bonds an efficient or inefficient method of helping issuing governments?

Mr. McKEE. Well, primarily the question has to do, it seems to us, with the supply-and-demand problem dealing with the tax-exempt bond market. The reason the short end of the market tends to be very efficient is because banks are able to secure the tax advantages that they want without taking any risk of dealing with fluctuations in interest rates or fluctuations in credit conditions of the issuer. So at the short end of the market they are able to engage in a pure tax arbitrage calculation which means that the subsidy gets almost fully passed through to the intended beneficiary.

As the maturity gets longer, banks begin to have less interest in investing in those longer term instruments, primarily because they don't want to tie up their funds so much in the long-term market and expose themselves to varying interest rates. Since they have less demand for those investments, the interest rate that has to be paid by the borrower goes up and the subsidy passthrough becomes much less efficient. Banks in essence compensate themselves for the risk that they perceive in investing in longer term bonds by capturing a significant portion of the tax subsidy that is inherent in the situation. And that's when, from the government's point of view, a big chunk of those lost revenues ends up in the banking sector and doesn't go to the borrower that you are trying to help.

The CHAIRMAN. Well, does the appearance of an inequity in our tax system contribute to lack of confidence? You know, there are 5 to 6 million nonfilers, as I understand, and there may or may not be any evidence that that is related at least to a feeling that the system is not fair. That's why some on this committee have been talking about a flat-rate tax—Senator Bradley and others—to try to improve confidence in the system.

It would seem to me, rightly or wrongly, when somebody reads a headline that somebody pays an effective rate of minus 12.4 or 2.3, and they are out there paying 25–35–40 percent, whether they are an individual or a business, there must be some concern if you don't fully understand the tax laws.

Mr. **McKee**. We agree with that, Mr. Chairman. The problem is that we need to review the subsidies that are inherent in the code that give rise to these very low effective tax rates. And you are quite correct—to the extent that the Tax Code is used to deliver subsidies instead of raise revenue, that leads to complexity and a perception of unfairness on the part of the average taxpayer.

We agree with that, and we support working with you to review on an ongoing basis, as we did last summer, the provisions in the Code that are delivering subsidies and to continue to inquire as to whether or not those social purposes justify—are still strong enough to justify—the existence of those subsidies.

And once again, in the banking area we note, as we just discussed, some of the provisions seem to perhaps have outlived their usefulness.

The **Chairman**. Senator Pryor.

Senator **Pryor**. I think Senator Bradley has a question. I may have one later.

Senator **Bradley**. Thank you, Mr. Chairman. Mr. McKee, in your statement on page 1 you say, "Any tax legislation affecting depository institutions and their products should reflect the significant changes that have occurred recently in the operation of all financial institutions." And then you go down the list and talk about banks, thrift institutions and life insurance.

And then you say, "As a consequence of the increasing similarity of products offered by different financial institutions, the tax treatment of the institutions and their products can greatly influence their relative competitive position."

Then on page 2 you conclude by saying, "Different tax rules for financial institutions and their products may also reduce and distort the flow of savings from their most productive uses."

My question to you is: Do you think all financial products should be taxed at the same rates?

Mr. **McKee**. Again, Senator, we believe that identical products ought to be taxed identically. In terms of the same rates, it seems to me that raises other issues as to whether or not you want to have a progressive rate structure for individuals, et cetera; but by and large there is no question that the same products ought to be given the same tax treatment, and simliar institutions ought to be taxed similarly.

It seems to us there is no reason for the dramatic proliferation of tax rules governing financial intermediaries in a world in which they all seem to be doing about the same things.

Senator **Bradley**. So would you support, then, the idea that all savings and investment income should be taxed basically alike?

Mr. **McKee**. I think you are raising other issues. For example, the policy of the Congress and the administration to favor retirement savings would argue that income which is put away for retirement ought to be taxed differently than income which is currently available for spending.

Senator **Bradley**. Well, it is not just a question of retirement. I mean, if we just go down the list of the way we tax income from savings and investment, we have a complete exemption for municipal bonds; we have a 60-percent exemption for long-term capital gains; you have interest and dividends taxed at the highest marginal rate—at 50 percent—and we have deferral on IRA's and pensions, and then we have a separate treatment for life insurance products that are investments.

The question is: What is the rationale for these differences? What is the substantive rationale? I mean, you are up here giving us advice on how we should reorganize the taxation of depository institutions; is there a rationale for these very different treatments of income from savings and investment?

Mr. McKEE. Senator, you are raising obviously major issues of the structure of our tax law. We agree with you that we should always and continually reexamine the disparate tax treatment of transactions that are largely similar—or, to the extent that they appear similar, try to determine whether or not they are in fact not similar.

The difference between capital gain and ordinary income, for example, is a line that is very difficult to draw but I think reflects a congressional judgment over a long period of time that gains on certain types of property is different than interest on bonds and therefore ought to be taxed differently.

We are perfectly willing to work with you to reexamine the fundamental structure of the income tax; indeed, the President has called for that reexamination to see if we can come up with a fairer and simpler tax. And we would be happy to work with you in attempting to accomplish that goal.

Senator BRADLEY. All right.

In the document that has been prepared by the Joint Committee on Taxation, it shows that the U.S. tax rate on U.S. income for banks is 2.3 percent; the foreign tax rate on foreign income is 38.1 percent; and the worldwide rate is 24.7 percent. Why do you suppose that occurs?

Mr. McKEE. It appears to us that on the domestic side, Senator, the banks are tax intermediaries in our system. They are used as vehicles to deliver large amounts of subsidies to other taxpayers in the system. Other countries apparently do not have such provisions, and basically tax banks on their profits.

As I mentioned, we have in effect an indirect burden imposed by the tax system on the banks to the extent that they are simply passing on a portion of the tax subsidy to its intended beneficiary, primarily State and local governments, private-purpose IDB borrowers, et cetera. I think that's what is driving those two numbers to be so disparate.

Senator BRADLEY. Could I ask one last question? Senator Dole suggested in his opening statement the possibility of user fees based on size of institutions. How would that work?

Mr. McKEE. Senator, the Treasury has given no consideration to such a taxing scheme, and I think it would be premature for me to try to comment on it without having had the opportunity to discuss it and analyze it with both members of my staff and with the Assistant Secretary.

Senator BRADLEY. Thank you.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Mr. Chairman, I want to commend you for holding these hearings. As you recall, last year when we got into the life insurance, as you mentioned in the life insurance industry there are very, very substantial sums. I think it was something like $7 billion over 3 years.

As has been mentioned in the statement by Mr. McKee here, the financial institutions have been undergoing tremendous change. I have been conscious of this, as we all have. I served in the Banking Committee for a couple of years. And so we have the credit unions absolutely changing their method of doing business due to the deregulation, and in effect they are banks, they are fiscal institutions, as are grocery chains and Sears, Roebuck & Co., and everybody else.

So I think it is overdue for us to take a look at this, and I look forward to participating with you as we proceed further in these hearings.

I don't have any specific questions. Thank you, Mr. Chairman.

The **Chairman**. I think there is one area that I know Senator Chafee is interested in. You know, we look very kindly on IRA's, and we have looked at a number—whether they are student IRA's or housing IRA's—that are just expanding the IRA program itself. We know that is a revenue-loser, but I would hope that we might have continuing input from Treasury on the effect of that program.

It seems to me that that's a program that not only may be of some help to financial institutions but it fits into social security and other things we are looking at, and we'd appreciate your continued interest in that area.

As you continue to study financial institutions and other groups you will be working with Treasury, whatever happens to anything else. I mean, this is not going to be a 1-day hearing and then everybody goes back to sleep.

Mr. **McKee**. That's correct, sir.

The **Chairman**. Thank you.

Mr. **McKee**. Thank you.

The **Chairman**. We now have Dave Brockway of the Joint Committee on Taxation. Dave succeeded Mark McConaghy as the director of that nonpartisan group that has been so helpful to this committee over the years and to the House Ways and Means Committee.

STATEMENT OF DAVID BROCKWAY, CHIEF OF STAFF, JOINT COMMITTEE ON TAXATION, U.S. CONGRESS

Mr. **Brockway**. Thank you, Mr. Chairman.

With me is Richard Gordon and Jim Wetzler of our staff.

I thought I would just go through some of the major aspects of the study which was released I guess the day before yesterday, our study on Taxation of Banks and Thrift Institutions, which we submit for the record.

Also, Mike is passing out some charts that may make it easier to explain some of the major points found in the study.

The study is in two parts: The first is an effective rate analysis, and the second is a discussion of the special provisions that lower the effective rate of tax on banks and also those provisions of general applicability that happen to be of particular significance to banks because of the nature of the industry.

In doing an effective rate study normally you would think of how much tax is paid as a percentage of economic income. Now, there is a great deal of dispute as to exactly what "economic income" is; and, in any event, even if you settle on a measurement, there is no real good data to compute it. So what the study basically does is summarize three different studies—they appear on page 15 in table 4 of the study—that measure taxes in relation to book income.

One study is drawn from the annual reports, the effective rate computed by the banks. There is a study published in Tax Notes Magazine; I gather that a witness later today will describe their study. Finally, there is a study that our staff prepared for Congressmen Pease and Dorgan that is summarized in the pamphlet.

I should point out in the beginning that these studies only deal with Federal income tax. Many of these taxpayers have other types of taxes—they may for example, have substantial State taxes—so that it does not necessarily give an accurate reflection of their aggregate effective tax rate.

Also, by using book income you have some substantial distortions, particularly if you look at 1 year at a time, because of differences in timing of book and tax income. But those distortions tend to wash out, if you look over a period of years, or if you look over a sufficiently large grouping of taxpayers.

Further distortions are created by the treatment of deferred taxes, taxes that companies incur with respect to income in the current year but don't have to pay until a later year—ACRS would be a good example. Those taxes, using our methodology, are not counted at all. So the methodology does understate the effective tax rates of the various taxpayers. How serious that distortion really is turns on how long the deferral is for the taxpayer. Equipment-leasing would be an example where it might not be that great a distortion if the taxpayer continues in the business and continues to roll over and defer the taxes so that the present value of the tax is not substantial.

The first two charts that we have illustrate the data on table 2 on page 9, which summarizes the effective rates under the Pease Study, the study that we prepared on an industry-by-industry basis.

The first chart shows the U.S. tax paid on U.S. income. The study only deals with large banks, by the way; we do not have a study of small banks because we did not have an adequate representative sample. By using book income, we needed to use publicly traded corporations who publish their annual reports.

We found that by this methodology the effective rate of commercial banks is relatively low. There are two industries—paper and wood products, and railroads—which had tax refunds even though they had book income. But after that commercial banks have the lowest effective rate. There are a number of other industries that pay substantially more tax.

For banks we show two different sales and that has been the cause of some confusion. They have a 2.3-percent effective rate of tax, using this analysis, if you don't count the three large commercial banks that have U.S. losses. If you take those U.S. losses into account, however, it goes up to a 2.7-percent effective rate of tax, using this methodology, on U.S. income in 1981.

Now, you also can see that there are a number of other industries that have significantly higher tax, such as motor vehicles. That example demonstrates a problem I mentioned before, that the differences between timing of book and tax income may lead to distortions if you only look at 1 year. Motor vehicles in 1980, rather than paying the 49 percent that they paid in 1981, only paid 13 percent. On the other hand, crude oil production, which was raised earlier this morning, had an effective rate of only about 3 percent in the study in 1981, but the year before the independent crude producers paid over 20 percent. Thus, in 1980 they were sort of in the mainstream of most industries.

So it is generally misleading if you only look at 1 year. But I can say that for commercial banks the rate has been relatively low in each year. In 1980, by our methodology, it was 5.3 percent, and it was relatively low in previous years. That's pretty much consistent in the various studies that look at banking, that banks tend to have a relatively low effective rate of tax, or at least nominal tax, as compared to other industries.

The second chart looks at worldwide tax on worldwide income. There are several things you can notice from this chart. First, most industries have a higher foreign rate than the U.S. rate, and there are a variety of questions that that raises—questions that get fairly complicated. Second, the rate for banks is noticeably higher on foreign income than it is on the U.S. income. It's sort of in the mainstream of other industries. A little later I will go into some of the possible explanations of why that is the case.

The next chart breaks down on a company-by-company basis the 1981 effective rate on U.S. income for the 20 largest commercial banks in the United States. Three banks are not shown. Citicorp and Manufacturer's Hanover aren't shown because they had U.S. losses for book purposes, even though they had very high foreign profits. There is another bank not shown, a smaller bank, for which we don't have the necessary data.

When looking at the bank-by-bank data, I think you have to look over a period of years to get a true picture. I don't think you can look at this and come to the conclusion that each year Bankers Trust, for example, pays a low tax, and each year Continental Illinois, for example, pays a relatively high tax. You have to look over several years before drawing conclusions like that.

The next chart shows the bank-by-bank worldwide effective tax rates on worldwide income. Bank of America, the first bank listed, has a 28-percent worldwide effective rate. Its foreign effective rate is almost 42 percent, but it has a negative rate in the United States. That means that on its U.S. income it is generating a refund of almost 12 percent.

The bank with the highest worldwide rate is Citicorp, which had a U.S. tax loss but a 45-percent foreign rate of tax. There is a similar pattern for most of the banks—they have a much higher foreign rate, which accounts for their higher worldwide rate.

The final chart breaks down the percentage of their worldwide income between U.S. and foreign sources. You can very easily see from this that for many of the large commercial banks, a substantial part of their book income is from foreign activities rather than U.S. activities. Both Citicorp and Manufacturer's Hanover have more than 100 percent of their income from foreign sources because they are reporting a U.S. loss, for book purposes. As this chart shows, about one-half of the banks are reporting more than one-half of their book profits from foreign sources.

The banks' 2 or 3 percent effective rate on U.S. income is largely accounted for by two factors. The principal item is their investments in tax-exempt obligations. The next most significant is the investment credit and ACRS benefits, or accelerated depreciation benefits, on their equipment-leasing activities—activities which they have been involved in for a number of years.

On the foreign income, I think that the higher effective rates are largely a matter of both higher foreign net income taxes and also gross withholding taxes, an item having a substantial impact on the banks.

As was pointed out in some of the discussion earlier, the effective tax rates in these studies only reflect the Federal income tax the banks pay to the U.S. Government or the foreign taxes they pay. The rates are not a measurement of the burden on the banks as a result of the U.S. tax system. There is what banks would describe, and I think maybe Bill McKee described, as an implicit tax. For example, where a bank invests in a long-term bond that is trading at a discount of perhaps 20 percent from the taxable rate, the bank is getting a reduced yield. So while it isn't paying any U.S. tax on that income, it is getting less income by virtue of the tax system than it would otherwise get.

You also have a reduced yield in equipment leasing. There it is not going to the governmental body that issued the bonds, or actually the private user if we have a private purpose revenue bond that is tax exempt, but it is going to the user of the equipment. Part of that benefit is spread to the intended user, and part is retained by the bank, as Bill McKee discussed.

Also, it doesn't reflect a number of other factors that are important such as the requirement that banks keep interest-free deposits with the Federal Reserve. That has a significant impact. The banks view that as a tax because the Federal Government does make money off of that. It may more properly be viewed as just the effect of a regulation that is a cost of doing business. If it is a tax, it is more in the nature of an excise tax. As I've indicated, however, it may be better to view it, for example, the way you would view regulation of natural gas, where obviously the owner gets a lower return as a direct effect of governmental regulation.

The second part of the study goes into the various reasons why the effective rates of banks are as low as they are.

The first area analyzed is bad debt reserves. Now that commercial banks are phasing down to an experience method, their tax bad-debt reserves are roughly comparable to their book bad-debt reserves, and so bad-debt reserves don't really account for a significant lowering of their effective rate of tax on book income. In fact, once they fully phase in to the experience method, they will probably take lower bad-debt deductions for tax purposes than they take for book purposes, because bank regulators would rather they take a conservative position for book purposes.

In the case of thrift institutions, there are the special bad-debt-reserve provisions intended to encourage investment in mortgages, and the resulting concentration of thrifts in mortgages, that Bill McKee discussed this morning. The policy issue is whether there should be that type of an incentive to invest in mortgages. I think that everyone would agree that this special reserve is not really an attempt to measure income.

The next area analyzed is the treatment of investments in tax-exempt obligations. That is the principal factor explaining why their effective rates are low. The way banks differ from other taxpayers is that, as a general rule, their deduction for interest on indebtedness incurred to carry tax-exempt obligations is not disallowed, whereas most taxpayers, if they borrow to carry tax exempts, lose their interest deduction.

This permits a bank to leverage itself into a situation where it can invest only a relatively small portion of its assets in tax exempts and eliminate its entire tax liability. Roughly speaking, it has to invest the same proportion of its assets in tax exempts as its profit spread bears to its interest income on taxable obligations. It generates no taxable income on the investment, but it is generating interest deductions which eliminate its tax liability.

In the materials we have an example of how a bank might profitably, on an after-tax basis, invest in tax-exempt obligations that yield it less money before tax than its cost of borrowing funds. The reason it would make the investment is to get the tax benefit from deducting its cost of borrowing funds, without being required to include the interest in income. I think that the principal issue here is that if you change that rule, it would have a substantial impact on whether the banks would invest in tax-exempt obligations and not whether this treatment accurately reflects their income.

The final item and probably the most important other item for the major banks is the tax treatment of their foreign operations. The last item in the materials is a chart which illustrates how their foreign tax credits work.

The issue here is whether the foreign tax credit rules and other rules dealing with their foreign income provide larger profits for banks in their foreign operations than in their domestic operations, or whether the rules otherwise create an incentive for the banks to lend overseas.

That issue arises principally in connection with the foreign tax credit and, there, principally in connection with the gross withholding taxes that a number of countries impose.

The first way that this might happen arises in connection with the source-of-income rules used in determining how much of their tax liability is attributable to their foreign operations. For book purposes, as I indicated earlier, roughly half of the income for these banks was attributed to foreign sources. I understand they use a tracing method for book proposes.

Under the rules the U.S. banks use for tax purposes, though, tax data indicates that in 1980 about 85 percent of their taxable income—this is after adjusting for their tax-exempt income—about 85 percent of it was from foreign sources, and in the 2 previous years about 75 percent was from foreign sources.

By increasing their taxable income from foreign sources, they increase their allowable foreign tax credits. The issue here is whether the current rules accurately determine foreign source taxable income.

The other major item possibly giving rise to an incentive to lend abroad is the treatment of gross withholding taxes. A number of jurisdictions impose withholding taxes at rates up to 25 percent and perhaps higher. Now, obviously, 25 percent of a bank's gross interest is, as a general matter, much higher than its net profit on the loan. So it is unlikely that the bank is going to bear the burden of that tax itself, because otherwise it would not make the loan.

There is an example in the materials of a situation where a bank would lend at a 10-percent interest rate, if no withholding tax applied, the cost of the bank's funds is 9 percent, and to a foreign country that imposes a gross withholding tax of 20 percent.

If you assume that the bank is not going to bear the burden of that tax, it's going to look at its after-tax yield to decide what it will do.

There are two possible results that will occur in that situation: One is that the Treasury will absorb the tax through allowing a foreign tax credit for that tax, even though that tax is much higher than the net income. The other possible result is the foreign borrower will absorb the tax by an increase in the interest rate to cover the tax.

So in this situation if an interest charge of 10 percent were charged and a 20-percent tax withheld, that would leave the bank only an 8-percent after-foreign-tax yield. Since its cost of funds is 9 percent; at this point it's a loan that the bank would lose money on, and it would not enter into it. But with the foreign tax credit, if the bank was not in an excess-credit position, it would be the Treasury that would effectively bear that 2-percent tax, and so the bank's after foreign taxes would have a 1-percent profit rather than a 1-percent loss.

If you assume otherwise that the foreign borrower would absorb the tax by increasing the interest rate, what would happen is that the interest rate would be 12.5 percent, the tax withheld would be 2.5 percent, and the before-credit yield of the bank would be 10 percent, the same as if the tax wasn't levied; but yield after the foreign tax credit would be 12.5 percent or a net profit after foreign taxes of 3.5 percent—substantially higher than it would otherwise obtain.

We have a couple of other examples here dealing with the situation where the bank is in an excess-tax-credit position. In that situation the bank would not have the same benefit, because they would not be able to use the foreign tax credit. However, it should be pointed out in that situation, if a bank is in an excess-foreign-tax-credit position from its loans to one jurisdiction, it may well lend to another jurisdiction where there is no foreign tax imposed, which is a typical situation in large part because of the U.S. treaty program where both sides agree to waive taxes. Given the fact that a bank can shift its source of income from one jurisdiction to another at no particular marginal cost, it does not need to move its business operations, it can fairly easily use these rules to make sure that it does not absorb the burden of these high foreign taxes—these taxes that are, as I said, significantly higher than the actual net income on that loan.

There are a number of other issues that we cover in substantial detail in the report. For now, though, I just will leave it with that.

The CHAIRMAN. Senator Long.

Senator LONG. You have had some very worthy predecessors, and I'm sure you will be a worthy success to them in your job, Mr. Brockway. One of them was Larry Woodworth. I guess you recall Larry pretty well, don't you?

Mr. BROCKWAY. Yes.

Senator LONG. You worked with him, didn't you?

Mr. BROCKWAY. Yes, I started under Larry.

Senator LONG. Some years ago when we were working on a tax reform bill I was rather pleased that we appeared to put together a bill in which those who were best able to pay and who were paying perhaps less than their share were made to pay a lot more.

I asked you to put together a chart showing who was the ultimate payor of those taxes. He went to work on it, and after a while he came back and said, "'Well, they had one basic problem they had to decide." And he asked me for my judgment. He said that the taxes we were levying on corporations, by taking away deductions or whatever we were doing, were, according to most economists, really being borne somewhere between 50 and 75 percent by the customer, so that these corporations were passing anywhere from 50 to 75 percent of that tax liability through to the public in the price of the product.

Now, that sort of amazed me at the time. I didn't think it was that high. But he said that most advice he was getting from economists would be that it would be nearer to the 75 percent than it would be to the 50 percent.

Now, what can you and Mr. Wetzler give me to help my thinking on that subject?

Mr. BROCKWAY. Well, I think I'm going to let Jim do it all. [Laughter]

Senator LONG. Well, could he speak for the two of you now?

Mr. BROCKWAY. Yes.

Senator LONG. Personally I like the guy. I'm not sure whether he's as good a tax lawyer as you are, but I think he's a good economist. Go ahead.

Mr. WETZLER. Well, you are asking really one of the questions that economists have been debating for as many years as we have had the corporate income tax, which is: Who really bears the burden of it?

Obviously, a corporation itself can't bear the burden of a tax; it's got to be some person, whether it is going to be the shareholders of the corporation, the workers who work for the corporation, or the customers, or whether the tax burden gets diffused very widely through the economy. It's a question, as I say, that has been debated, and it's still being debated.

There has been a lot of analytical work done on it in the last 10 or 15 years, since Larry prepared that material for you, and I'm sure if Larry were able to have access to this thinking he might have changed his view a little bit.

I might add that a lot of the work has been done up at the National Bureau for Economic Research under Martin Feldstein, who is now the administration's chief economist.

Senator **LONG**. Now give me the best information you can, based on your knowledge of this matter. What percentage of the increase of taxes on a corporation tends to be borne by the consumer?

Mr. **WETZLER**. Well, there are some industries where clearly almost all of it is borne by the consumer—public utilities are an obvious example, where the regulatory commission just automatically passes the tax on to consumers. Unfortunately a lot of utilities don't pay much tax these days; in fact in some cases the regulatory commission passes on to consumers more than 100 percent of the tax because of the normalization rules that are in the Internal Revenue Code.

Senator **LONG**. Well now, what's your guess for the banks?

Mr. **WETZLER**. Well, you know, banks don't pay that much tax. If Congress changes the law so that they did, the answer to your question would depend on precisely how we raised the money.

Senator **LONG**. Now, we are talking about increasing their taxes here. That's what we came to talk about. They are paying some taxes. Now, to what extent are they passing it through?

Mr. **WETZLER**. Dave and I aren't talking about increasing their taxes; we are just analyzing.

Senator **LONG**. Oh, you didn't come here to advocate that? [Laughter.]

The **CHAIRMAN**. They are not policy guides.

Mr. **WETZLER**. But I would say if we did something in the State and local area, obviously that some of the burden of that and possibly a lot of the burden of that would be borne by the State and local governments.

If we did something in the equipment-leasing area, probably a lot of the burden of that would be borne by the users of the equipment.

In the foreign area, which is the third big area, it's very hard to say. We have to look into that more, and we've got to do a lot more research into that question. I think that's an area where it is really unclear how much of it would be borne by foreign borrowers, how much of it would just lead to less foreign lending and more domestic lending. It's just a very complicated problem.

Senator **LONG**. You made an interesting point here, and Bill Simon has used the same expression from time to time. He said that the corporations don't pay taxes, it's the people that pay the taxes. The corporation is owned by individuals, and in the last analysis you are either taxing the people that own that corporation or else you are taxing somebody else on the consuming end.

Mr. **WETZLER**. That's right. It's going to be one or the other, very likely. Yes.

Senator **LONG**. Thank you.

The **CHAIRMAN**. Senator Bradley.

Senator **BRADLEY**. Thank you, Mr. Chairman. You really went out on a limb on that last one. [Laughter.]

The **CHAIRMAN**. I've been there before. [Laughter.]

Senator **BRADLEY**. It's either one or the other. [Laughter.]

Now let's assume that we did change our laws so that the effective U.S. rate of tax on banks went up. What would this do to their worldwide rate?

Mr. **BROCKWAY**. If their effective tax on U.S. income——

Senator **Bradley**. You have a 2.3-percent effective tax rate on banks' U.S. operations, and their foreign tax rate is—according to the data that you have submitted—about 38 percent. If we raise the U.S. rate, what would happen to the foreign rate?

Mr. **Brockway**. If you raised the effective U.S. rate, not the statutory 46 percent, well then the aggregate would just go up.

Senator **Bradley**. The worldwide rate would then go up—is that right?

Mr. **Brockway**. Correct.

Senator **Bradley**. What would happen to their net profits?

Mr. **Brockway**. Depending on the answer to Senator Long's question about who bears the tax, whether they can pass it forward, presumably the net profits would go down.

Senator **Bradley**. What would then happen to their competitiveness with other financial intermediaries?

Mr. **Brockway**. In the U.S. market?

Senator **Bradley**. And worldwide.

Mr. **Brockway**. Well, I don't know that it would affect their competitiveness in the foreign markets if you raised their effective rate on U.S. operations. But in the U.S. market, presumably it would make them less competitive compared to other institutions—the mutuals, savings and loans, credit unions, insurance companies, whoever is providing a similar service.

Senator **Bradley**. Do you think that's advisable?

Mr. **Brockway**. I think you have to look at all the financial institutions and make a judgment. It also depends upon how you increase their effective rate. It may or may not have that impact.

For example, the mutual savings banks and the savings and loans will testify later today that, in years when they haven't had the substantial losses which they have had in the last couple of years, their effective rate has been in the mid-teens. Now, we haven't examined that data, and I don't know whether that is correct. But, competing in the same market, they would argue that they are paying a higher effective rate than the commercial banks are.

Senator **Bradley**. Can you identify any economic effects of cutting back dramatically on their foreign lending? What effect would that have on our domestic economy?

The **Chairman**. Jim is the economist.

Senator **Bradley**. I mean to ask the panel that, not just one.

Mr. **Wetzler**. Well, again, obviously I don't think you want to precipitately change the incentives the banks have so that they suddenly pull back all of their foreign loans and you have some sort of worldwide crisis.

I think in certain circumstances there clearly are incentives to the banks to lend abroad rather than lend at home; in other cases the system works the other way. It depends just on what the tax situation of the bank is, what the tax rate of the country is, and what sort of tax treatment you have.

Senator **Bradley**. What do you mean "worldwide crisis"? How would that happen if you did change this dramatically?

Mr. **Wetzler**. Obviously there is a certain amount of danger right now since a lot of these foreign countries into which banks all over the world, including ours, have lent are having a little trouble paying the debts.

If all the banks started to withdraw their loans in these countries, the countries would default, and I think you would clearly have a serious problem.

And as I understand it, the Treasury, the Fed and the IMF are working very hard to make sure that doesn't occur.

Senator **Bradley**. OK. Let me ask you one other question.

In your analysis you talk about some of the benefits that accrue to banks and some of the penalties, more or less. And you implied that the amount of deposits that banks have to maintain at the Federal Reserve interest-free is a form of penalty. Is that really so? And what banks do not have to hold deposits with the Federal Reserve?

Mr. **Wetzler**. Well, I think they are phasing-in a rule under which all financial institutions will have to maintain more or less the same reserve requirements, and that in effect means they have got to take a certain fraction of their assets and not earn any interest on them. From the standpoint of the economic system, it's one way that we try to maintain control over the money supply, and it's an important element of monetary policy.

But from the banks' standpoint, it is in effect a regulation that reduces their earning power. Now, I think their concern is that the money market funds don't have reserve requirements, and they have got to compete with the money market funds.

Senator **Bradley**. But what do banks get out of that agreement? I mean, if you have to hold a certain amount of money interest-free at the Federal Reserve, you are also the member of a system that ultimately provides a lender-of-last-resort. Is that not correct?

Mr. **Wetzler**. Yes, they get access to the discount window; but of course they have to pay.

Senator **Bradley**. And before there was a Federal Reserve, when there were crises like in Tennessee last week or in Texas last year, those banks, the depositors, and the shareholders just lost. Is that not correct?

Mr. **Wetzler**. That's right.

Senator **Bradley**. So there is a rationale for the Federal Reserve and participation in the Federal Reserve?

Mr. **Wetzler**. Oh, yes. I don't think that the banks would argue that they don't want to have a Federal Reserve System. I think they would probably like to have interest paid on the reserves that they keep at the Fed.

Senator **Bradley**. So essentially what you are saying is that that would be free participation? They want to have the advantage of having a lender-of-last-resort without having to participate in the system in a way that doesn't generate income. Is that not correct?

Mr. **Wetzler**. I think all they have really asked the joint committee staff to do is to give them a little credit for this in our effective-rate studies.

The **Chairman**. I think that lack of interest is sort of a user-fee for using the system.

Senator **Bradley**. That's where I was leading the questions, to say what Senator Dole had suggested earlier about a user fee is in effect this deposit at the Federal Reserve.

The CHAIRMAN. That could be one definition.

Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

I was looking at Senator Metzenbaum's testimony, and he says "the Tax Code says taxpayers may not deduct interest on obligations used to finance the purchase of tax-exempt securities. But the tax laws exempt banks from this requirement." And that's labeled a "special interest tax break" and you touched on that in your testimony, Mr. Brockway.

But if we should change that, as there was a suggestion that we were going to do last year, as you recall, the ramifications upon municipal authorities or other authorities issuing tax-exempt bonds would be extraordinary, would it not?

Mr. BROCKWAY. Well, actually, you did cut back last year by reducing the deduction for interest paid on indebtedness incurred to hold tax-exempts. You cut it back by 15 percent in your general preference cutdown.

Certainly if you eliminate the deduction entirely, that would take a substantial segment of the buyers out of the market for tax-exempt obligations, particularly short-term obligations where the banks are primary buyers.

It is not clear, however, whether increasing what you did last year by disallowing 15 percent of the deduction would decrease or increase the demand for tax-exempt obligations or at least long-term obligations, because one effect of the disallowance is that banks, in order to reduce their taxable income to the same extent, have to purchase more tax-exempt bonds. So it is not quite clear what impact it has when you have a disallowance of deduction, at a relatively low level.

Senator CHAFEE. That was a very modest disallowance.

Mr. BROCKWAY. That's correct.

Senator CHAFEE. But if you disallowed it completely——

Mr. BROCKWAY. It clearly would have an impact.

Senator CHAFEE [continuing]. The effect on the ability to issue such bonds or the rate you would issue them at would be changed very dramatically.

Mr. BROCKWAY. It clearly would have a significant impact.

Senator CHAFEE. I think the point here is that, as you mentioned in your testimony, everything that is in the code is in there for what we looked on at one time or another as a purpose. Now, maybe we want to change those purposes. Certainly we want to get equal treatment. And that's what I find is going to be best out of these hearings, is because of the growth of these other institutions that are treated unlike banks, or that banks are now being able to participate in their business and they are treated differently. So it's this equity that we are seeking through here, as far as I'm concerned.

I appreciate your testimony.

Thank you, Mr. Chairman.

The CHAIRMAN. Along that same line, Dave, what would be the result if Congress allowed banks to deduct only half the cost of carrying tax-exempt bonds, but also allowed the broker-dealers the same tax treatment?

Mr. Brockway. Well, you would obviously have a substantial decrease in the amount of buying that banks would do, but a substantial increase in the amount that the broker-dealers would acquire.

I think that for banks, once you start disallowing a significant portion of the interest deductions then you would start discouraging the acquisition of bonds fairly clearly. But in that proposal you would be offsetting it by purchases by broker-dealers. I don't know how it would net out. We would just have to look at that.

The Chairman. And also you have touched on the general question that many of the larger banks make a lot of loans overseas and make much of their income abroad and still pay only moderate worldwide taxes. Have you been able to determine whether there is any incentive to lend abroad rather than at home? You know, if the Tax Code is geared in a way that encourages lending abroad rather than lending here, that might get into interest rates and a number of other things that we don't have jurisdiction of.

Mr. Brockway. Well, Mr. Chairman, we are just at the initial stages of that study. I went through two possibilities of how the gross withholding taxes imposed overseas and our allocation of the deduction rules could cause that result. We are going to have to do more analysis to see whether and to what extent that does happen; but certainly there are tendencies in the system that could have the result that it would be more attractive to lend abroad for a bank than to lend in the domestic market.

The Chairman. I think I mentioned in my statement about one analyst at Smith-Barney who suggested that a corporate surcharge might result in banks paying more taxes, and at the same time help issuers of tax-exempt bonds. Do you agree with that?

Mr. Brockway. Well, assuming they bought the tax-exempt bonds, then there probably wouldn't be any increase in the banks' tax other than the fact that they probably would be getting a lower yield on their tax-exempts because there would be a greater demand generally for tax-exempts if marginal rates were raised. But certainly it would help the issues.

The Chairman. Well, again I want to thank the joint committee and indicate that you are not testifying in the policy area, you have been helping us out in the technical area. And we appreciate your help in putting together the preliminary study.

We will be working with the joint committee, not just in this area—I would have to underscore that. We are looking at other areas as well as the financial institutions, but I think that's an obligation we have.

Senator Chafee. Mr. Chairman.

The Chairman. Yes?

Senator Chafee. Mr. Chairman, I would urge that you do pay particular attention to the overseas loan situation and the ramifications of us changing the tax situation there, because it goes far beyond taxation and revenues; as you mentioned, it gets into a host of other areas that certainly we want at least brought to our attention. Some of them we are aware of—the IMF and other situations—but I would hope you would point them out to us.

Mr. Brockway. Very definitely, Senator. At this point I want to make it clear that this analysis, on what is happening in the foreign area, is very preliminary. We have to do a great deal more research. We are not sure whether it does in fact provide an incentive to lend abroad and what impact it would have if you changed the rules in that area. But we will certainly look into that.

Senator CHAFEE. Yes, the impact far beyond revenues.

Mr. BROCKWAY. Exactly.

Senator BRADLEY. Mr. Chairman, if they could answer a question for me it would be helpful—on this question of whether there are incentives to lend abroad versus lending at home, how that is possible if the effective foreign tax rate is 38 percent and 2 percent at the domestic level. You don't have to give that answer today.

Mr. BROCKWAY. All right. But generally what it would be is that in order to reduce your domestic effective rate—for example, if you invest in tax-exempts—you have to accept a reduced yield. So if you can lend overseas and pay no tax, you prefer to do that. Part of the question is whether these taxes are in fact borne by the borrower, reflected in higher interest rates, or borne by the Treasury.

Senator BRADLEY. It might be helpful if you could show for each one of these what if they were eliminated or half was eliminated, what the effective tax rate would be domestically. I think that would be helpful from my standpoint.

Mr. BROCKWAY. Sure. That information is contained in tables 5 and 6 of the study, which show how much various factors contribute to the reduction of the banks' effective rate of tax on worldwide income.

The CHAIRMAN. Thank you very much.

Mr. BROCKWAY. Thank you.

The CHAIRMAN. We now have a panel of witnesses: Richard C. Kaplan, associate professor of law, College of Law, University of Illinois; Fred Wertheimer, president, Common Cause; Don Fullerton, assistant professor of economic and public affairs, Woodrow Wilson School, Princeton University.

Let's see. Mr. Kaplan, do you want to lead off?

I would say in advance that your entire statements will be part of the record, and if you could summarize it might be helpful. We still have 12 witnesses. We will have an afternoon session starting at about 1:30, but we will try to go to about 12:30 now, if we can.

STATEMENT OF RICHARD L. KAPLAN, ASSOCIATE PROFESSOR OF LAW, COLLEGE OF LAW, UNIVERSITY OF ILLINOIS, CHAMPAIGN, ILL.

Mr. KAPLAN. In view of my prepared statement, I will try to be brief.

I am a law professor at the University of Illinois and a certified public accountant and have been involved in the analysis of effective corporate tax rates since 1974. This has not been a subject of just the last couple months with Tax Analysts and their publication, Tax Notes.

It was in 1973 that the Securities and Exchange Commission began requiring disclosures of Federal tax burdens for the first time. That was when Tax Analysts and I got involved in trying to determine just what these disclosures meant. Unfortunately, most of the corporate disclosures were in such various forms—some in dollars, some in percentages, different base figures—that there was no useful way of comparing one company to another. This then became the principal purpose of the Tax Analysts' project—to obtain comparable figures for different industries and different companies.

Those studies have been reported since 1974 and have recently received much attention, primarily because of the low effective tax rates shown for commercial banks. I might mention that the particular sample involved only 29 banks out of some 500-plus companies, but it has been these tax rates that have attracted the most attention.

One of our findings since 1974 has been that effective tax rates for this particular industry are the lowest of any industry; that is, this phenomenon of low tax rates for commercial banks is not a curiosity of the last year or two.

The reasons for these low effective tax rates are several; they have been set forth in the previous testimony as well as in my prepared statement, so I will focus on only a few dimensions here:

One, the single largest factor reducing commercial bank taxes is their ownership of municipal bonds. Any corporation, or any individual for that matter, may purchase municipal bonds, but more than half of all municipal bonds are held by commercial banks. It is clear, as Mr. McKee has indicated, that some of the differential in bond yield goes to the States and municipalities that issue those bonds, but a substantial portion—in his estimate approximately a third, and in some computer simulation studies at least that much—is strictly a subsidy to the banks. This is a rather curious arrangement because the exemption of tax on municipal bond interest is thought of as a subsidy local governments exclusively. It certainly is a subsidy for them, but it is also a subsidy for the middlemen, in particular, the commercial banks.

A second major contributor to the low effective corporate tax rates for banks is leasing operations—very similar in nature to the operations that this committee substantially tightened last year. Those restrictions largely did not affect commercial banks, for they had been arranging leasing transactions since the early sixties and continue to do so. All the equity arguments and concerns that this committee had in 1982 apply in large measure to these leasing operations as well, and their production of accelerated depreciation deductions and investment tax credits. The studies that Tax Analysts have done do not impugn particular tax incentives but rather try to call the attention of the Congress to the effect that these incentives, when combined with other exemptions and incentives, have on the effective tax rates of particular industries. But certainly one question should be raised about leasing operations, and that has been a question not yet addressed this morning—namely, if Congress felt that safe harbor leasing should be restricted, as was done in 1982, then why are these substantially similar deals unrestricted?

One other provision merits some comment: capital gains, a major structural component of our tax system. Any corporation is eligible for capital gains treatment, but most companies obtain such treatment only on assets unrelated to their regular business. In the case of commercial banks, which are substantial holders of bonds—corporate and municipal, however, they are able to obtain capital gain treatment on assets that are very much a part of their regular business.

These three provisions—leasing, municipal bonds, and capital gains—as shown by the charts that Tax Analysts have published, are the principal ways that commercial banks have lowered their tax rates.

The CHAIRMAN. Thank you very much, Mr. Kaplan. We will have some questions.

[Mr. Kaplan's prepared statement follows:]

PREPARED STATEMENT

of

RICHARD L. KAPLAN

For the U.S. Senate Finance Committee

March 11, 1983

Mr. Chairman, I am a law professor at the University of Illinois and a certified public accountant as well. I teach in the areas of tax law, tax policy, and accounting for lawyers and have been involved in the analysis of effective corporate tax rates since 1974. It was in that year that publicly-held corporations began disclosing pertinent information about their federal tax obligations in their annual reports to stockholders. These disclosures were mandated by the Securities and Exchange Commission to determine the principal divergences between net profits as reported to stockholders and as reported to the Internal Revenue Service. Thus, for the first time, stockholders, financial analysts, and other interested readers could determine why a company was paying less than the statutory rate -- currently 46% -- of its net income in taxes.[1]

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1. See generally Kaplan, Effective Corporate Tax Rates, 2 JOURNAL OF CORPORATE TAXATION 187 (1975).

Unfortunately, the form these disclosures took in company reports was so variegated that meaningful comparisons were virtually impossible. Some data were in dollars, others in percentages; some included state and local taxes, which are deductible against federal taxes, while others included foreign income taxes, which usually are creditable. So it was that I undertook, along with the policy-oriented journal Tax Notes, to analyze these disclosures and to organize the data into some useful format. The result was a series of charts, organized by industry, of major corporations showing their effective tax rates and the principal reasons why those rates differed from the statutory rate. These charts have been published in Tax Notes for calendar years 1973 through 1981, and 1982 will be undertaken as soon as the corporate reports start coming in.

From the beginning of this project, several significant conclusions became clear:

First, effective corporate tax rates vary greatly from industry to industry and even from company to company within the same industry.

Second, these effective corporate tax rates are usually less than the statutory rate and have been declining steadily since 1973.

Third, the major causes of these low effective rates are various tax incentives created by Congress for one reason or another: investment tax credits, accelerated depreciation on business assets, preferential rates on "capital gains," and so forth. In addition, there are other tax incentives with special significance for particular industries due to the nature of those industries. For example, the exemption of income earned in U.S. possessions is enjoyed predominantly by drug companies, the exemption of most dividend income is used primarily by insurance companies, the exemption of municipal bond interest is very important to commercial banks, installment sales reporting is of particular benefit to retailers, and so forth.

Attention has been directed in recent weeks to the part of our project dealing with commercial banks, primarily because the effective tax rates for this industry seem conspicuously low. And indeed they are. For 1981, the most recent year available, the twenty-nine largest publicly-held banks had an average U.S. rate on U.S. income of negative 12.6%.[2] That is, although these banks reported net profits to their shareholders, they reported net losses to the I.R.S. Thus, the banks owed no U.S. taxes and in fact had potential refund claims against taxes paid in prior years.

Actually, this situation is not really new. In 1980, the banking industry's average rate was also negative, this time a negative 1.9%. And in each earlier year studied, commercial banks as a group had the lowest effective tax rate of any industry surveyed. Moreover, those rates were always small, even when positive.

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[2] The charts for 1981 are attached as an appendix.

The major reasons for these low tax rates are as follows:

1. Leasing operations -- generate investment tax credits and accelerated depreciation on business assets "owned" by banks but actually used by other corporations. In basic outline, these arrangements resemble the "safe-harbor" leases created in 1981 and substantially restricted last year. The banks' arrangements, however, preceded 1981 and are largely unaffected, therefore, by the 1982 amendments.

2. Municipal bonds -- interest on these bonds is exempt from federal tax. Any corporation can acquire state and local bonds, of course, but financial institutions hold over half of these obligations. Consequently, this tax exemption is uniquely important to these institutions.

3. Capital gains -- the lower rate applicable to "capital gains" is also available to business corporations generally, but once again, this preference has special significance for major holders of corporate and municipal instruments, such as commercial banks.

4. Bad debt reserves — the tax code (section 585) allows a bad debt deduction to be calculated without regard to actual experience. In the past, this provision has been a significant

factor in reducing banks' taxes, because the formula exceeded the bad debt expense reported to shareholders by a multiple of three or more. In recent years, however, this factor has been much less significant, largely because actual bad debt experience has worsened for domestic as well as foreign loans. Moreover, the statutory formula is being phased out and will be eliminated entirely after 1987.

Thus, commercial banks reduce their taxes primarily by such well-known devices as the investment tax credit, accelerated depreciation, municipal bonds, and capital gains. All of these mechanisms are available to business corporations generally, although the latter two have particular significance for financial institutions.

A few concluding caveats should be noted, however. First of all, our analyses rely exclusively on publicly available data. Actual tax returns are confidential, needless to say, so only company-prepared information has been used. Secondly, no attempt has been made to "verify" this information. That is, we have no way of knowing whether the banks' equipment really qualifies for accelerated depreciation, whether the investment credit is properly claimed, whether the treatment of certain profits as "capital gains" is accurate, and so forth. Only a full-scale I.R.S. audit can answer these questions.

Thirdly, the tax "provisions" reported in financial statements do not necessarily correspond to the actual taxes paid by that company. Typically, a company's private auditors include some padding or "cushion" to cover questionable positions or "aggressive" interpretations taken on the company's tax returns. This procedure is done primarily to protect investors, but the inevitable consequence is that a company's actual tax burden may well be less than the tax rate reported in our studies.

In any case, our charts do not purport to challenge the wisdom or appropriateness of specific tax provisions, be they investment tax credits or the municipal bond exemption. They do, however, dramatize the effect of those provisions on particular companies and industries. When, as in the case of financial institutions, those provisions render an industry virtually exempt from federal income tax, questions may indeed be raised about the usefulness of those provisions, and such questions should be considered seriously.[3] Hopefully, our studies help to encourage such serious consideration.

RLK:dlr

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[3] See also Kaplan, The Issue Is Corporate Tax Breaks, Not Their Tax Rates, 14 BUSINESS & SOCIETY REVIEW 39 (1975); reprinted with statistical appendix as Disparity in Corporate Rates Raises Questions About Underlying Tax Policy, TAX NOTES, Nov. 17, 1975 at 13.

1981 Corporate Federal Tax Burden

COMMERCIAL BANKS I

Weighted industry averages (10 companies)—worldwide rate: 18.4%; foreign rate on foreign income: 37.5%; U.S. rate on U.S. income: (9.4%).[11]

	Bank America	Bankers Trust	Chase Manhattan	Chemical Bank	Citicorp	Continental Illinois	First Chicago	First Interstate	Manufacturer's Hanover	J.P. Morgan
Pre-Tax Earnings (in 000's)[1]	$647,950	253,799	564,041	288,312	812,000	373,250	145,309	266,310	377,521	513,800
State and Local Income Taxes[2]	(50,000)	(8,084)	(34,475)	(52,728)	(19,000)	(12,206)	(5,800)	(15,000)	(61,679)	(63,700)
Worldwide Base Figure[3]	**597,950**	**245,715**	**529,566**	**235,584**	**793,000**	**361,044**	**139,509**	**251,310**	**315,842**	**450,100**
Statutory Rate	46.0%	46.0	46.0	46.0	46.0	46.0	46.0	46.0	46.0	46.0
Permanent Items:[4] Investment credit[5]		(0.8)		(1.9)	(2.3)	(11.3)		(5.7)		(1.1)
Tax-exempt income	(7.6)	(19.6)	(18.3)	(24.6)	(5.7)	(13.5)	(22.7)	(38.6)	(18.1)	(22.7)
Capital gains		(2.1)	(3.5)		(1.8)		(3.2)	(5.3)		
Foreign income tax rates	(3.3)	2.1			1.0					
Miscellaneous[6]	3.2	(3.8)	(2.0)[14]	(6.6)	(4.2)	3.7	(2.8)[14]	2.4	(2.4)	0.6
DISC[7]										
Quasi-Permanent Items:[8] Accelerated depreciation and deferred income from leasing activities	(11.2)	(14.2)	(4.1)	(8.2)	(5.2)	(5.2)	(6.2)	(6.0)	(12.2)	(5.2)
Provision for loan losses					3.4			3.9	8.4	
Worldwide rate on Worldwide Income	**27.1**	**7.8**	**18.1**	**4.7**	**31.2**	**19.7**	**11.1**	**3.2**	**18.4**	**17.6**
Foreign Base Figure[9]	**449,000**	**199,712**	**435,000**	**92,454**	**860,720**	**126,820**	**39,300**	**39,000**	**349,987**	**273,400**
Foreign Rate on Foreign Income	**41.2**	**30.6**	**31.6**	**65.2**	**45.3**	**48.7**	**55.5**	**15.4**	**24.4**	**23.8**
U.S. Base Figure[10]	**148,950**	**46,003**	**94,566**	**143,130**	[13]	**234,224**	**100,209**	**212,310**	[13]	**176,700**
U.S. Rate on U.S. Income	**(15.4)**	**(92.4)**	**(44.1)**	**(14.9)**		**3.9**	**(6.3)**	**1.6**		**7.9**

[1] Excludes the results of discontinued operations, equity income from unconsolidated subsidiaries, and income taxes. Equity income is excluded because it is not part of the reported entity's taxable income. Discontinued operations are excluded to promote comparability with other companies.

[2] Earnings before income taxes, as shown on a firm's income statement are reduced by the provision for state income taxes because state income taxes are merely another deduction for purposes of federal taxation. The base figure which results from this subtraction is a more accurate standard for comparison with the federal statutory rate.

[3] The worldwide base figure is used as the denominator in calculating the percentages reported below.

[4] Permanent differences are items such as credits, deductions or exclusions from taxable income which are not intended to be recaptured under the provisions of the Internal Revenue Code. The classification of permanent differences shown in the table is based on the corporation's classification of these items in its Form 10K reports filed with the Securities and Exchange Commission.

[5] The percentages shown reflect the credit earned on assets placed in service during the tax year. For those companies which choose to account for the credit on the deferred method rather than the flow-through method, the percentages shown will not correspond to a company's reconciliation of actual tax burden to the statutory rate for financial accounting purposes.

[6] Items constituting less than 2.3% of net earnings before federal income taxes are not required by the Securities and Exchange Commission to be separately reported. These items are often shown as miscellaneous on SEC reports.

[7] Inclusion of DISC profits in taxable income may be deferred indefinitely if certain conditions are met. Some companies account for such deferral as a permanent difference, others show it as a quasi-permanent difference. Tax Notes reports the effect of DISC in a separate category to avoid having to choose between these two approaches.

[8] The quasi-permanent items are those items of deferred taxes which, in the judgment of *Tax Notes'* accounting consultant, will probably not be recaptured through taxation in future years. Such items, therefore, reduce the current tax bill and will not increase future tax bills. Hence, the tax reductions to which they give rise are, in effect, permanent.

[9] The foreign base figure represents foreign pre-tax income determined under U.S. tax laws.

[10] Assumes that all equity income and quasi-permanent items are attributable to U.S. operations unless otherwise disclosed by the company.

[11] For 1980 figures, see *Tax Notes*, March 31, 1982, p. 940.

[12] Includes amounts for foreign withholding.

[13] Operations incurred a loss.

[14] Includes equity income in earnings of affiliates.

1981 Corporate Federal Tax Burden

COMMERCIAL BANKS II

Weighted industry averages (10 companies)—worldwide rate: 4.8%; foreign rate on foreign income: 40.3%; U.S. rate on U.S. income: (22.0%).[11]

	Crocker National	First Bank System	First Nat'l. Boston	Irving Bank	Marine Midland	Mellon National	National Detroit	Northwest Bancorp.	Security Pacific	Wells-Fargo
Pre-Tax Earnings (in 000's)[1]	$69,600	108,842	177,354	135,203	118,316	124,278	45,142	103,850	331,159	155,362
State and Local Income Taxes[2]	(6,812)	(12,171)	(17,999)	(14,726)	(11,281)	(1,177)	[12]	(7,699)	(31,501)	(11,722)
Worldwide Base Figure[3]	**62,788**	**96,671**	**159,355**	**120,477**	**107,035**	**123,101**	**45,142**	**96,151**	**299,658**	**143,640**
Statutory Rate	46.0%	46.0	46.0	46.0	46.0	46.0	46.0	46.0	46.0	46.0
Permanent Items:[4]										
Investment credit[5]	40.3	(3.4)	(0.4)	(4.0)	(6.0)	(6.0)	(4.4)		(1.9)	(7.7)
Tax-exempt income	(26.4)	(53.3)	(18.5)	(21.2)	(17.5)	(36.3)	(82.5)	(41.2)	(6.6)	(16.0)
Capital gains										(3.6)
Miscellaneous[6]	(1.6)	(0.1)	(1.1)	(1.3)	(1.4)	2.5	(3.7)	1.6	(2.4)	(5.0)[13]
DISC[7]										
Quasi-Permanent Items:[8]										
Accelerated depreciation and deferred income from leasing activities	(34.1)	(7.2)	(0.8)	(9.6)	(6.1)	(10.6)		(9.1)	(29.6)	(22.3)
Provision for loan losses	13.0	1.6		2.0			(0.2)	0.4		
Installment sales								(1.0)		
Worldwide Rate on Worldwide Income	**37.2**	**(18.4)**	**25.2**	**11.9**	**18.0**	**(4.4)**	**(44.8)**	**3.3**	**5.5**	**(8.8)**
Foreign Base Figure[9]	**60,648**	**12,728**	**86,390**	**57,907**	**42,680**	**20,579**	**20,128**	**[12]**	**46,872**	**93,000**
Foreign Rate on Foreign Income	**41.0**	**11.8**	**66.5**	**24.7**	**34.8**	**85.8**	**31.9**		**48.9**	**29.1**
U.S. Base Figure[10]	**2,140**	**83,943**	**72,965**	**62,570**	**64,355**	**102,522**	**25,014**	**[12]**	**252,786**	**50,640**
U.S. Rate on U.S. Income	**(1,786.3)**	**(20.6)**	**(23.8)**	**0.2**	**1.8**	**(22.6)**	**(108.1)**		**(2.2)**	**(61.3)**

[1] Excludes the results of discontinued operations, equity income from unconsolidated subsidiaries, and income taxes. Equity income is excluded because it is not part of the reported entity's taxable income. Discontinued operations are excluded to promote comparability with other companies.

[2] Earnings before income taxes, as shown on a firm's income statement are reduced by the provision for state income taxes because state income taxes are merely another deduction for purposes of federal taxation. The base figure which results from the subtraction is a more accurate standard for comparison with the federal statutory rate.

[3] The worldwide base figure is used as the denominator in calculating the percentages reported below.

[4] Permanent differences are items such as credits, deductions or exclusions from taxable income which are not intended to be recaptured under the provisions of the Internal Revenue Code. The classification of permanent differences shown in the table is based on the corporation's classification of these items in its Form 10K reports filed with the Securities and Exchange Commission.

[5] The percentages shown reflect the credit earned on assets placed in service during the tax year. For those companies which choose to account for the credit on the deferred method rather than the flow through method, the percentages shown will not correspond to a company's reconciliation of actual tax burden to the statutory rate for financial accounting purposes.

[6] Items constituting less than 2.3% of net earnings before federal income taxes are not required by the Securities and Exchange Commission to be separately reported. These items are often shown as miscellaneous on SEC reports.

[7] Inclusion of DISC profits in taxable income may be deferred indefinitely if certain conditions are met. Some companies account for such deferral as a permanent difference; others show it as a quasi permanent difference. *Tax Notes* reports the effect of DISC in a separate category to avoid having to choose between these two approaches.

[8] The quasi-permanent items are those items of deferred taxes which, in the judgment of *Tax Notes'* accounting consultant, will probably not be recaptured through taxation in future years. Such items, therefore, reduce the current tax bill and will not increase future tax bills. Hence, the tax reductions to which they give rise are, in effect, permanent.

[9] The foreign base figure represents foreign pre-tax income determined under U.S. tax laws.

[10] Assumes that all equity income and quasi-permanent items are attributable to U.S. operations unless otherwise disclosed by the company.

[11] For 1980 figures, see *Tax Notes*, March 31, 1982, p. 901.

[12] Not disclosed.

[13] Includes gain on redemption of debt.

1981 Corporate Federal Tax Burden

COMMERCIAL BANKS III

Weighted industry averages (9 companies)—worldwide rate: 13.8%; foreign rate on foreign income: 00.0%; U.S. rate on U.S. income: 13.8%.[11]

	Bank of Iowa	Bank South	First Georgia Bank	First Glen Bancorp (Glens Falls, N.Y.)	First Nat'l. Bank Allentown (Pa.)	First Nat'l. Cincinnati	First Nat'l. Lincoln Corp. (Neb.)	First Security Corp. of Ky.	First Virginia Banks
Pre-Tax Earnings (in 000s)[1]	$15,133	12,310	3,222	1,756	5,768	34,329	8,916	8,305	25,081
State and Local Income Taxes[2]	(1,139)	[12]	[12]	(220)	[12]	[12]	100[15]	[12]	[12]
Worldwide Base Figure[3]	**13,994**	**12,310**	**3,222**	**1,536**	**5,768**	**34,329**	**9,016**	**8,305**	**25,081**
Statutory Rate	46.0%	46.0	46.0	46.0	46.0	46.0	46.0	46.0	46.0
Permanent Items:[4] Investment credit[5]	(3.7)	(3.0)	(18.4)		6.8	(7.3)	(2.0)	(2.6)	
Tax-exempt income	(38.9)	(38.0)	(11.8)	(55.6)	(82.0)	(18.0)	(24.1)	(23.5)	(16.1)
Miscellaneous[6]	7.1	(1.5)[13]	0.6	5.0	25.2[14]	(0.3)	1.3	(4.4)	(3.4)[16]
DISC[7]									
Quasi-Permanent Items:[8] Accelerated depreciation and leasing	(5.2)	(11.0)	(1.6)	1.8			1.8	(15.3)	(6.1)
Loan losses		4.3		0.4					3.8
Worldwide Rate on Worldwide Income	**5.3**	**(3.2)**	**14.8**	**(2.4)**	**(4.0)**	**20.4**	**23.0**	**0.2**	**24.2**
Foreign Base Figure[9]									
Foreign Rate on Foreign Income									
U.S. Base Figure[10]	**13,994**	**12,310**	**3,222**	**1,536**	**5,768**	**34,329**	**9,016**	**8,305**	**25,081**
U.S. Rate on U.S. Income	**5.3**	**(3.2)**	**14.8**	**(2.4)**	**(4.0)**	**20.4**	**23.0**	**0.2**	**24.2**

[1] Excludes the results of discontinued operations, equity income from unconsolidated subsidiaries, and income taxes. Equity income is excluded because it is not part of the reported entity's taxable income. Discontinued operations are excluded to promote comparability with other companies.

[2] Earnings before income taxes, as shown on a firm's income statement are reduced by the provision for state income taxes because state income taxes are merely another deduction for purposes of federal taxation. The base figure which results from this subtraction is a more accurate standard for comparison with the federal statutory rate.

[3] The worldwide base figure is used as the denominator in calculating the percentages reported below.

[4] Permanent differences are items such as credits, deductions or exclusions from taxable income which are not intended to be recaptured under the provisions of the Internal Revenue Code. The classification of permanent differences shown in the table is based on the corporation's classification of these items in its Form 10K reports filed with the Securities and Exchange Commission.

[5] The percentages shown reflect the credit earned on assets placed in service during the tax year. For those companies which choose to account for the credit on the deferred method rather than the flow-through method, the percentages shown will not correspond to a company's reconciliation of actual tax burden to the statutory rate for financial accounting purposes.

[6] Items constituting less than 2.3% of net earnings before federal income taxes are not required by the Securities and Exchange Commission to be separately reported. These items are often shown as miscellaneous on SEC reports.

[7] Inclusion of DISC profits in taxable income may be deferred indefinitely if certain conditions are met. Some companies account for such deferral as a permanent difference; others show it as a quasi-permanent difference. *Tax Notes* reports the effect of DISC in a separate category to avoid having to choose between these two approaches.

[8] The quasi-permanent items are those items of deferred taxes which, in the judgment of *Tax Notes'* accounting consultant, will probably not be recaptured through taxation in future years. Such items, therefore, reduce the current tax bill and will not increase future tax bills. Hence, the tax reductions to which they give rise are, in effect, permanent.

[9] The foreign base figure represents foreign pre-tax income determined under U.S. tax laws.

[10] Assumes that all equity income and quasi-permanent items are attributable to U.S. operations unless otherwise disclosed by the company.

[11] For 1980 figures, see *Tax Notes*, March 31, 1982, p. 900-01.

[12] Not disclosed.

[13] Includes amounts attributable to safe harbor leasing.

[14] Includes amounts attributable to carryforward of tax loss.

[15] Reflects refund.

[16] Includes investment tax credits.

The CHAIRMAN. Mr. Wertheimer.

STATEMENT OF FRED WERTHEIMER, PRESIDENT, COMMON CAUSE, WASHINGTON, D.C.

Mr. WERTHEIMER. Thank you, Mr. Chairman.

I want to commend the committee for these hearings and for the work it has done over the past year to begin to reverse the process of a tax system that is dominated by special tax preferences.

The study just released by the Joint Tax Committee certainly appears to show that the banking industry, because of the cumulative impact of a series of tax preferences, has a privileged status in the tax system. The fact that they are one of the most powerful interest groups in the country is probably not unrelated to that privileged status.

The study shows why this hearing is appropriate. Congress should be very carefully examining how and why the banking industry has achieved the status of being among the lowest-paying industries in the tax system.

Congress also should be very carefully questioning whether it is fair and equitable for it to continue that way. If it's not, then the Congress should be considering legislation to change it.

We also believe, however, it is important to recognize the larger question raised here—the need for Congress to pay far greater attention to the whole system of tax preferences that exists today. At a minimum, Congress should be periodically and systematically looking at the almost $300 billion in tax preferences that exist now to see if they are fair and equitable. And that of course is all the more urgent given the huge deficits the country faces, and I'm very glad to hear the chairman say that this is the beginning of a series of hearings that will attempt to do that.

That approach was certainly the philosophy underlying last year's important tax bill. In our view it is a correct philosophy and should be carried forward in this Congress.

Ultimately, as the committee knows from our testimony last year, we hope to see the day when the tax system will move away from being so based in special tax preferences.

There was discussion earlier about whether this hearing was related to the amendment pending on the floor. The hearings may not be directly related to the amendment being on the floor today—and I leave it for the committee to explain the relationship between the hearing and that amendment—but the tax status that the banking industry has in America is directly related to what is going on on the floor today, because both of them flow from exceptional and at times very distorted power that the banking industry can exercise in this country and in Congress.

Earlier this morning Senator Metzenbaum said:

> People take advantage of preferences—those preferences aren't the fault of the people taking advantage of them, they are our fault in Congress—we give them the preferences.

Well, I will partially agree with the Senator, but I would add that those preferences don't wind up in the code by accident; they don't simply come out of the interests of the Congress; they come out of power and the exercise of power.

Bankers and the banking industry are known for their commitment to fiscal responsibility and prudence, and I'm sure the banking industry is deeply committed to reducing the Federal debt. That commitment appears to be much stronger, however, when it applies to others than when it applies to the banking industry. That at least is the impression one would get from the provision that is pending in the Senate today and from the impact of the tax structure on the effective rate that the banking industry is paying in this country.

I think the special-interest nature of our present tax system can be vividly seen in the effort to repeal the tax withholding provisions. Our organization withholds taxes for the Government, so do millions of others. It costs us money to do so; it's an administrative burden for us to do it. I wonder whether the banking industry is interested in repealing withholding of income and social security for my organization and for the millions of other organizations that exist in this country that do it?

That fight going on is very important in the larger scheme of things, because it is a fight over whether or not we can continue with the philosophy that began with last year's tax bill, of trying to address a system that is permeated with preferences, or whether we cannot continue that philosophy.

So I think the action and the fight is directly related to the question of what the banking industry's effective rate is. We support the efforts of the chairman and others to continue that withholding provision, and we hope very much you are successful, because we think it will directly impact on whether or not we as a country can make some progress away from a tax system dominated by interest preferences to one that is more equitable, a move that is all the more important in an era of $200 billion deficits.

Thank you.

The CHAIRMAN. Thank you, Mr. Wertheimer.

[Mr. Wertheimer's prepared statement follows:]

TESTIMONY OF FRED WERTHEIMER

PRESIDENT OF COMMON CAUSE

Thank you, Mr. Chairman and Members of the Committee, for the opportunity to testify today on the taxation of banks and other financial institutions. Although our testimony focuses on tax provisions that affect financial institutions, our concerns relate to problems that afflict the entire federal tax system. That is, we see the taxation of financial institutions not as an isolated issue, but as an illustration of pervasive problems that this Committee and the Congress should address.

We would like to thank you at the outset, Mr. Chairman, for the leadership you have provided this year and last in removing some of tax system's serious inequities and in defending those improvements once enacted. We hope that you will continue to focus attention on the crucial issue of tax equity as you and the Committee address the nation's revenue needs in the 98th Congress.

REVENUE AND EQUITY

Raising revenue is the principal purpose of any tax system. As we testified before this Committee last September, the public has a right to expect that needed revenue will be raised in ways that are fair and that ensure compliance by all taxpayers. But our tax laws increasingly have failed to achieve these objectives. The result, as we noted last fall, has been widespread public dissatisfaction with the tax system, as revealed by a number of recent surveys. We are here today to stress that the changes we advocated then are needed more than ever: the tax base must be broadened, compliance with our tax laws must be improved, and public faith in the tax system must be restored. The specific issue we address today -- taxation of financial institutions -- illustrates in particular the need to distribute the burden of taxation fairly, and without regard to the influence of powerful special interests.

The 1981 Tax Act

The treatment of tax preferences in the 1981 tax law -- the so-called "Economic Recovery Tax Act" -- did severe damage to the dual needs of revenue and equity. That Act cost the government billions of dollars in revenue as it created new tax preferences and expanded existing ones. The resulting revenue drain contributed to our present deficits, currently estimated at more than $200 billion in fiscal year 1983. The new and expanded tax breaks created by the 1981 Act also undermined the equity of the tax system, since they increased the disparate treatment of income from different sources, provided disproportionate benefits to the wealthiest taxpayers, and further diminished the corporate share of the tax burden to about 6 percent, down from nearly 25 percent during the early 1960s.

The Influence of Special Interests

One reason for the proliferation of tax preferences and the tax system's increasing inability to raise revenue fairly has been the steady growth of special interest influence in the tax lawmaking process. Many corporations, trade associations and labor groups have wielded their influence to shape the tax system to their own needs. That influence approached all-time high levels -- and the integrity of the tax system approached all-time lows -- during the infamous "bidding war" that produced the 1981 Act. Lear jets packed Washington's airports as a horde of corporate executives and lobbyists swarmed over Capitol Hill, seeking special tax breaks for their firms and industries. In addition, Political Action Committees (PACs) representing various special interests contributed almost one-half million dollars in campaign contributions to members of the Ways and Means Committee in the five months surrounding the Act's passage. As Chairman Dole has noted, "when these PACs give money, they expect something in return other than good government." Such special interest contributions strike at the heart of public confidence in a tax system that relies fundamentally on public trust and voluntary compliance.

The Tax Equity and Fiscal Responsibility Act of 1982

In response to the escalating deficits and public outcry over inequity that the 1981 Act created, Congress, led by this Committee, passed the Tax Equity and Fiscal Responsibility Act of 1982. While TEFRA did not solve all of the tax system's problems, it repealed or restricted several of the most inequitable tax preferences. In doing so, the Act slowed the steady erosion of the tax base and the growth of deficits that previous tax measures -- particularly the 1981 tax Act -- had exacerbated. In addition, several key provisions of the Act encouraged greater compliance, especially among those taxpayers who have escaped paying their fair share through use of tax shelters or receipt of non-wage income. Together these provisions constituted an important first step toward rebuilding public confidence in a tax system too often perceived as benefiting the wealthy and influential at the expense of the average taxpayer.

THE CONTINUING NEED TO RESTRICT TAX PREFERENCES AND ENHANCE EQUITY

TEFRA was only one step in the right direction. The task of closing unfair tax preferences and ridding the tax code of its special interest domination remains an enormous one. Public support for the tax system depends on a widespread perception that the system is fair. That perception will be fostered only if Congress commits itself to transforming the current tax system -- a patchwork of special interest provisions -- into a fair and effective instrument for raising revenue.

Restricting Tax Preferences: The Tax Treatment of Commercial Banks

The tax treatment of commercial banks illustrates the need for further congressional scrutiny of the tax system.*/ According to a study released this week by the Joint Committee on Taxation, the twenty largest U.S. banks paid an effective rate of 2.7% in corporate income taxes on their domestic income in 1981. And six of those banks actually paid negative effective tax rates -- a graphic illustration of the abundance of legal means available for reducing tax liabilities. Of all industries, banks paid the third lowest tax rate on U.S. income in a year when their profits grew almost three times faster than the average for all industries.*/ Several provisions in the tax code combine to allow banks to reduce and, in many cases, eliminate their tax liabilities. These provisions include:

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*/ Although our general discussion of tax preferences applies to other financial institutions, we will restrict our comments here to commercial banks for two reasons. First, unlike thrift institutions, they are generally in financial good health. Second, unlike credit unions, commercial banks are taxable corporations with a vested interest in reducing their tax liabilities.

1. Tax-Exempt Municipal Bonds. Commercial banks are the largest purchasers of tax-exempt municipal bonds. The tax-exemption for municipal securities was designed to provide an indirect federal subsidy to state and local governments. Yet the largest reduction in bank tax rates is attributable to their holdings of these securities. While any taxpayer may purchase tax-exempt bonds, banks have special incentives to do so. Unlike other investors, banks can deduct the interest they pay on customer deposits used to purchase or carry tax-exempt bonds.

2. Leasing. For twenty years, commercial banks have been allowed to engage in leasing transactions; that is, purchasing equipment to qualify for investment tax benefits and then passing part of those benefits on to non-taxpaying entities in the form of lower lease payments. Like other leasing corporations, banks can purchase equipment with borrowed money and then lease it, thus leveraging their investment and sheltering greater amounts of income.

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*/ As reported in "Corporate Scoreboard," Business Week, March 16, 1981, May 17, 1982, and March 14, 1983.

As with the indirect subsidy from municipal bonds, leasing constitutes an indirect federal subsidy to tax-exempt organizations and non-taxpaying corporations. But as is the case with municipal bonds, a portion of the tax subsidy serves to reduce bank rates.

3. Foreign-source Income. As is true for other corporations, banks may credit against their U.S. tax liability the foreign taxes paid on their income earned abroad. In addition, they may defer payment of any remaining U.S. taxes on income from their subsidiaries until it is repatriated. Foreign tax rules were adopted to avoid double taxation of income earned abroad, which would discourage overseas operations of U.S. corporations. Yet because banks have expanded their foreign operations about three times as fast as their domestic operations in the last ten years, these provisions have significantly lowered their effective U.S. tax rates.

4. Bad Debt Reserves. Banks are also allowed a tax deduction for additions to their bad debt reserves. This deduction can be calculated using the "experience" method -- reflecting an average of their bad debt losses actually incurred during the previous six years -- or the "percentage" method -- reflecting a portion of their total noninsured loan assets. Under a 1969 tax law, the percentage method is to be gradually phased out of existence, disappearing altogether by 1988.

We recognize that each of these provisions raises complex issues of tax policy.*/ Yet their cumulative effect is to enable banks to pay one of the lowest effective tax rates of all U.S. industries. That result raises serious questions. Certainly the American public deserves to know why banks appear to bear so little of the national tax burden. Therefore, we urge the Congress to re-examine these and other tax provisions available to banks, focusing on their cumulative effect, as well as their individual merits.

But we wish to make a larger point. Congress must periodically re-examine tax preferences throughout the tax code, both individually and in terms of their cumulative effect on the equity with which tax liabilities are distributed. Such a review of tax preferences is especially urgent in this period of high budget deficits. Those provisions that Congress finds excessive should be restricted. Those that are failing to meet their objectives efficiently should be replaced, preferably with direct spending programs. And those that are no longer justifiable should be repealed. That was the philosophy embodied in TEFRA, and that is the philosophy that should guide future tax policy for banks, for other financial institutions, and for all areas of the tax system.

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*/ For example, banks may pay "implicit" taxes as a result of carrying municipal bonds. "Implicit" taxes refer to the reduced income banks and other financial institutions may receive as a result of acting as financial intermediaries. As discussed above, banks may have lower effective tax rates because they buy substantial amounts of tax-exempt municipal bonds. But tax-exempt bonds typically pay a lower rate of return than taxable bonds. Thus, banks "implicitly" lose the difference between the return on their municipal bonds and the rate they would otherwise have received on taxable securities. It is unclear, however, how much consideration Congress should give such implicit taxes. After all, other indurtries also pay implicit taxes due to regulation or other duties that the laws impose.

The Need to Protect Previously-Enacted Improvements

The task that lies ahead will not be easy, because special interests will lobby against your efforts every step of the way. They will also lobby to undo accomplishments already achieved, but Congress must vigorously resist those efforts. For good tax legislation passed one year, but repealed soon after by a Congress under pressure, can be more harmful to the tax system than no reform at all. Retreat in that fashion merely confirms the public's cynical view of the tax system: that it is easily manipulated to suit the special needs of narrow interests.

The difficulty of sustaining needed tax reform is well illustrated by the current campaign to repeal withholding on interest and dividend income. Withholding -- a key provision in TEFRA -- was adopted to raise revenue by improving taxpayer compliance on interest and dividend income.*/ Withholding was also adopted to promote equity. It treats income and dividend income in the same manner as wage income by requiring that taxes be paid as income is earned rather than once a year. And it promotes equity among income groups because those who receive substantial interest and dividend income are disproportionately upper-income taxpayers.

However, financial institutions have lobbied for years against withholding. Unwilling to help the government collect taxes -- a responsibility most employers and retailers have shouldered for decades -- they have now mounted a massive campaign to repeal the provision. Able to contact millions of Americans in the course of their normal business dealings, commercial banks and thrift institutions have issued misleading statements about withholding, frightening their depositors into opposing this instrument of good tax policy. Using such deceptive slogans as "ten percent of the money you earn in interest is going to disappear," they have implied that withholding will deprive depositors of substantial income and may even drive them to financial ruin.

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*/ Compliance for such income is now less than 90 percent, compared to 99 percent for wage income.

In reality, the Treasury has estimated the cost to taxpayers will be small. On a $1,000 account invested at 9 percent, for example, the cost to the taxpayer would be only about fifty cents, or less than one percent of the interest that would otherwise compound. Nor will the administrative burden on banks be unreasonable. TEFRA allows banks to defray their first-year administrative costs by giving them use of the withheld funds for 30 days. In addition, last week the Treasury announced that it would give the banks an extra six months (beyond the original six month extension that was included as part of TEFRA) to implement their withholding systems for some types of accounts and securities.

Thus, Congress has prudently reduced both the budget deficit and the inequities of the tax system by enacting a sound, justifiable tax provision. And yet members are now faced with mounting pressure to repeal it. The financial industry's campaign has helped generate volumes of constituent mail opposing withholding. In response, Congress should expose the misinformation in the industry's campaign and publicly defend last year's legislative accomplishments, not retract them. This challenge will face Congress every time it improvec the tax system over the objection of some special interest. But every time, it should hold fast to TEFRA's philosophy: that tax equity and fiscal responsibility, and not the concerns of special interest groups, should shape this nation's tax policy.

CONCLUSION

Congress must acknowledge what the public already perceives, that tax preferences reduce fairness when special interests use them to reshape the tax system to suit their own needs. And Congress must continue to recognize -- as it did in TEFRA -- that tax preferences are not a costless way of achieving public objectives. Because they cause inequity in the tax system and reduce revenues to the Treasury, Congress must carefully scrutinize all new and existing tax breaks, including those that benefit banks and other financial institutions. Those deemed absolutely necessary must be recognized as a form of government spending, with resulting revenue losses reviewed periodically and recovered elsewhere if growing deficits are to be contained. Others must be restricted or eliminated altogether. That is the only approach to take if Congress is to raise revenue in a manner that is fair and that inspires public confidence.

The CHAIRMAN. Mr. Fullerton.

STATEMENT OF DON FULLERTON, ASSISTANT PROFESSOR OF ECONOMIC AND PUBLIC AFFAIRS, WOODROW WILSON SCHOOL, PRINCETON UNIVERSITY, PRINCETON, N.J.

Mr. FULLERTON. Thank you.

Mr. Chairman and members of the committee, I appreciate this opportunity to be here.

A number of different studies have been reported this morning, and they all seem to show that the effective tax rate on banks is lower than the effective tax rate paid by other industries. Also, a number of people testifying have given reasons why that is so, namely tax-exempt bond interest, leasing, and such.

I won't go into that further, but I would like to ask, with those low effective tax rates in mind, what are the economic effects of those low effective tax rates? What are the effects on the distribution of income? What are the effects on efficiency and productivity of the economy?

Well, first of all I think that some of the discussion this morning has been misleading in talking about a bank as a taxpayer institution.

Along the lines that Senator Long was suggesting earlier, I think we should not be interested in the welfare of nonhuman entities such as banks or corporations or institutions. Instead we should be interested in the welfare of individuals—investors, workers, or consumers. The point is that unfair treatment of banks is just not an issue of any importance.

We might be concerned with an unfair treatment of the owners of the banks, but I would like to argue that the low effective tax rates on banks do not provide any advantages to the owners.

Most commercial banks are large corporations with many shareholders, and the stock is held very widely. When these special provisions were first enacted, and the after-tax profits of the bank went up, the stockholders at the time would all reap a windfall gain. The reason they would reap a windfall gain is that other potential stockholders would be willing to pay more for that stock in order to acquire the rights to that higher return.

But the point is that subsequent stockholders, new buyers of bank stock, by paying that higher price and perhaps earning that higher profit, are only receiving a normal rate of return. The entire benefits go to the windfall capital gains of the people who hold the stock at the time of the tax change.

So current stockholders are not receiving any unfair advantage in the way of a higher rate of return. The stock market insures that they cannot receive a higher rate of return on average than in other investments, or else more investments would flow right in and bid away that higher return.

As a result, I think that some of the discussion of equity is misdirected. In fact, to the extent we are concerned about equity, we might be more concerned instead about the windfall losses that would occur to the owners of the bank if we were to raise the taxes back up; because then, when the net profits are reduced, the price of the stock would have to fall for a new purchase of bank stock to yield the same rate of return as other investments.

These kinds of equity comments argue against making any tax changes at all, because the tax changes result in capricious windfall capital gains and losses. Losses do not accrue to those who made earlier gains, because the corporate stock has changed hands.

Aside from these equity arguments I would like to turn to some considerations of efficiency. There are problems with having different effective tax rates on different industries. The resources of the economy are misdirected, in a sense. If there were no taxes at all, or if all industries were taxed similarly, then the great American entrepreneurs would know just what to produce and how to produce it so as to satisfy the needs of consumers.

But when the Government steps in and applies differential tax rates—high rates in some industries, low rates in others—that allocation of resources is affected, and the private economy cannot produce the same real value of products that it otherwise would be able to produce.

I have a simple-minded example to illustrate this: If we were to have 99 percent tax rates on all commodities in the economy except for the production of cabbage, we could produce a heck of a lot of cabbage. We could produce it very efficiently. We could use the right combinations of land and labor and machinery, but it wouldn't be the right output. It would be a perfectly efficient technology, but it would not be an efficient or healthy economy. We would be producing way too much of one thing and too little of another.

That is a very simple and extreme example, but there are reasons to believe that the same kind of thing goes on with less extreme examples. Because of the differential taxation of banks versus other industries, there is reason to believe that there is too much banking going on. There is too much provision of banking services relative to the healthy economy where the entrepreneurs allocate resources so as to produce what the consumers want in the correct mix.

These tax differentials serve to misallocate resources and reduce productivity, and this is something with which we ought to be concerned.

I have some suggestions for reform in the written testimony and I am willing to answer questions on those reforms, but I see that my time has ended for these verbal remarks.

Thank you.

[Mr. Fullerton's prepared statement follows:]

Statement of

Don Fullerton

Assistant Professor of Economics and Public Affairs
Princeton University, Princeton, NJ 08544

before the

Finance Committee
United States Senate
March 11, 1983

Mr. Chairman, and members of the Committee, I appreciate this opportunity to come and tesify before you.

By some incredible coincidence, the Washington Post just yesterday reported a study by the Joint Committee on Taxation finding that the nation's twenty largest banks paid 2.7 percent of their 1981 income in taxes. This effective tax rate is considerably below the rates paid by most other industries in the study. I'm not sure how this study came to be released just before these hearings on bank taxation, but it does provide us with a useful framework for discussion. Some of the questions raised by this study include:

1. Are banks' effective tax rates really that low?
2. If so, why are they so low?
3. What are the effects on the distribution of income?
4. What are the effects on productivity and real output of the economy?
5. What reforms might be suggested to improve matters?

These five questions represent far more than I can cover adequately in the few minutes available, so I will discuss some in more depth than others.

First, it is difficult to deny that banks have low effective tax rates. Different studies have been undertaken by the Joint Committee on Taxation, by the journal Tax Notes, and by academic economists with which I am familiar. These studies differ in their methodologies and results, but they all generally support the notion that banking as an industry is taxed less than other industries.

Second, it is generally recognized that banks pay low effective tax rates because of special provisions that are available only to them. Most of us are not allowed to deduct interest payments on funds that are borrowed to finance the purchase of tax-exempt municipal bonds. Banks, however, can undertake such borrowing without limit, deduct the interest paid, and exclude the additional tax-exempt interest receipts. They pay an implicit tax because the municipal bond rate that they earn is less than the taxable rate that they pay, but effective tax rate measures typically exclude this implicit tax.

Banks also receive large deductions for bad-debt reserves. Because of complicated rules that are specific to the banking industry, these deductions usually exceed the actual losses that banks experience. As a result, this provision also reduces tax as a proportion of net income.

The newest mechanism for tax avoidance is potentially the biggest. When a U.S. bank lends to a U.S. corporation, interest receipts are taxable income to the bank. The same loan, however, can be run through a Caribbean subsidiary of the bank. Income there is not taxed until repatriated, so effective tax rates are again reduced. The net effect of these and other provisions is that taxes for banks are essentially voluntary. Banks could make use of these provisions more than they do, but there are other costs involved, and at least occasional payment of tax is better for public relations.

Most would probably conclude that these provisions represent unfair advantages for banks. This inference is misleading, however, for several reasons. First of all, we should not be interested in the welfare of non-human entities such as banks, corporations, or other institutions. We should instead be interested in the welfare of individual investors, workers, or consumers. Unfair treatment of banks is just not an issue of importance. We *might* be concerned with unfair advantages to owners of the banks, but I would like to argue that low effective tax rates on banks do not provide any advantages to their owners.

Most commercial banks are large corporations with many shareholders. When tax advantages were first introduced, years ago, competitive forces in the stock market undoubtedly bid up the price of bank stock. Those who held bank stock *at the time* enjoyed a windfall capital gain, but any new purchaser of bank stock would pay more for the stock and thus earn only a normal rate of return. Most current holders of bank stock have purchased their stock since the tax advantages were introduced, and they are receiving only a normal return on their investment.

The stock market insures that current holders of bank stock do no better or worse, on average, than current holders of other stock. Indeed, current bank owners have good reason to object to legislative changes in those tax advantages for banks, because any tax increase would probably result in capital *losses* for them. If higher taxes reduce net-of-tax profits, then the price of bank stock would have to fall for new investors to earn the same expected rate of return in any investment.

Moreover, any tax change results in capricious redistributions. The introduction of tax advantages provided windfall capital gains to some individuals, and their removal would provide windfall capital losses to *different* individuals, since the great bulk of corporate stock changes hands so rapidly.

To summarize these comments on redistributions, it is extremely unlikely that current bank owners receive unfair advantages. Concern about equity should be directed at windfall losses to current bank owners that would result if their taxes were raised.

Despite these redistributions, there might be good reason to eliminate tax preferences for banks. While these tax preferences don't provide higher rates of return to investors, they do provide considerable incentive to invest more resources in the banking industry. When the allocation of resources is changed in this way, the economy produces the wrong mix of outputs with a lower real value.

Let me explain this phenomenon with a simple-minded example. With no taxes in the economy, profit seeking entrepeneurs will produce just what consumers want to buy. If there are no external benefits or costs such as pollution, then Adam Smith's invisible hand works well. Suppose however, that 99 percent tax rates were imposed on the production of all outputs except "cabbage." Lower net returns in the taxed industries encourage producers to shift their resources into the untaxed industry until, as above, net after-tax rates of return are made equal. Lots more cabbage will be produced, with perfectly efficient combinations of land, labor, and machines. Because other goods are made more expensive, consumers will buy the additional cabbage. Clearly, however, it would not be a healthy economy.

This extreme tax differential implies very high costs to society, but less extreme tax differentials imply the same kinds of costs. We encourage certain kinds of equipment with investment tax credits, but we often forget that the additional equipment comes at the expense of other investments in buildings, inventories, or intangibles.

Similarly, higher taxes on other activities encourage more banking activity. These banking services have value and are produced perfectly efficiently, but, unless there is some good reason to believe that banking services confer general benefits to individuals other than the direct producers and consumers of banking services, there is too much of it.

Resource misallocations reduce the real productivity of the economy.

Clearly, this tax differential could be eliminated by raising the tax rate on banks, back to the level of other industries. Then all would be affected similarly, and we would not have too much of one at the expense of another. If we were to attempt to impliment a comprehensive income tax, this approach would be the correct one.

As an alternative reform, however, I would like to recommend a comprehensive consumption tax. As argued above, we ought to be concerned with fair treatment of individuals, and this kind of equity is difficult to achieve by taxing institutions such as businesses. After all, high-income businesses are often owned by many low-income individuals, and low-income businesses are often owned by high-income individuals. As a result, taxation of high-income businesses cannot accomplish goals regarding fair treatment of individuals.

Under a comprehensive consumption tax, there is no need to operate separate taxes on business at all. Individuals simply report all forms of income, and deduct all forms of savings through qualified accounts such as IRA accounts without ceilings. If those funds are used to invest in business, or banks, which make profits, then the individual is taxed on those profits when he withdraws them from the account to spend. The resulting tax base for different individuals can be subjected to a schedule that is as progressive as desired.

Finally, of course, this reform would put banks on the same footing as other businesses and thus remove distorting effects of tax differentials.

The CHAIRMAN. Senator Long.

Senator LONG. No questions.

The CHAIRMAN. Senator Pryor.

Senator PRYOR. Mr. Fullerton, in your opinion, what would be the effect if we did not allow banks to deduct interest when they borrow money to purchase the tax-exempt bonds? What would be the overall effect on the tax-exempt bond market?

Mr. FULLERTON. Well, in the tax-exempt bond market, it probably would result in less of a subsidy to the State and local municipalities. But of course the amount of that subsidy is related to Federal revenue loss, so that would be a way to raise revenue. Part of that revenue increase would come at the expense of the State and local governments, and some would come at the expense of the banks.

Senator PRYOR. So, if we did not allow the banks what some might call "a break," then the consumer on the State and local level would have to pay a tax increase to support such things as sewers, streets, and water-improvement districts?

Mr. FULLERTON. That is possible, yes.

Senator PRYOR. What do you think about the bank stock issue? I was interested in the rate of return for the stockholder on bank stocks.

It is my understanding that bank stocks generally have not been an attractive investment. It is my understanding that they don't really get a very large rate of return, and this has been the case for the last 3 or 4 years.

Mr. FULLERTON. That speaks directly to my remarks earlier.

Senator PRYOR. Right.

Mr. FULLERTON. Just an efficient working of the stock market would suggest that you can't do better buying one stock, on average, than you can by buying any other stock. So I would not expect the bank stocks to be doing any better as a rate of return for an investor even with these tax advantages. That's why I say that removing the tax advantages would create a windfall loss for those current bank stock owners.

Senator PRYOR. You mentioned in your written statement, which I read earlier today, that some banks have engaged in possible Caribbean-based bank companies or maybe French banking in the Caribbean. And, that these entities are used as a way to avoid taxes. Is this correct?

Mr. FULLERTON. Yes.

Senator PRYOR. To what extent does this go on?

Mr. FULLERTON. I'm sorry I don't have figures with me. In discussing this with some of my colleagues at Princeton, that was suggested as a major upcoming way for banks to avoid taxes. The suggestion was that it is not used very extensively now, but that it may be more so.

By the way, if the interest deductibility on the borrowing used to finance tax-exempt municipal bonds is removed, and they lost that tax break, then they would be likely to find others such as these foreign tax breaks.

Senator PRYOR. Mr. Kaplan.

Mr. KAPLAN. Yes, Senator Pryor. I would like to add something on that. The use of offshore tax havens primarily for banking industry loans is neither particularly obscure nor particularly recent. There was an article in the Wall Street Journal for February 4, 1983, involving this sort of switch, having loans that were allegedly French for U.S. purposes, and allegedly United States for French purposes. As one who practiced law in Texas for several years, I was well aware of these techniques. Indeed, if one was representing a major bank and was unfamiliar with offshore banking modalities and the various tax incentives—particularly the allocation of interest between United States and foreign sources, he was probably guilty of professional malpractice.

Senator PRYOR. Thank you.

That's all, Mr. Chairman. Thank you.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

Mr. Wertheimer, I would like to ask a question if I might. What you stressed in your testimony was the feeling that the banks have been getting away with murder, that they have gotten all kinds of preferences, that these preferences should be curtailed. And I'm not arguing with that.

But if you look at banks, banks have not been an area that has been a very good investment. I doubt if the price of any major bank stock has ever reached what it was in 1970, for example. And that's not even counting inflation.

If you look at growth companies, if banks aren't there, if you look at who has made a lot of money in the country, they have been real estate developers, and fast-food eaterie kings, and oil field magnates. But you don't read about bankers very often except maybe the Butcher Brothers, and they haven't done too well.

So I am just asking this: Suppose we did everything asked, we eliminated these preferences, and the major preferences go to areas, as Senator Pryor mentioned and we have mentioned here, in the revenue bonds and tax-exempt bonds—well, let's take that specifically.

So we do that. Then where are we? Is that an improvement as far as the national interest goes, in your judgment?

Mr. WERTHEIMER. Well, I would like to reframe a little bit the question that I think has to be looked at by the Congress.

The Congress enacts a series of different preferences. It's only when you look at the cumulative impact of those preferences on the banking industry that you then find out that they are among the lowest payors of effective tax rates.

I don't think we can point to a value judgment that has been made to date that says, "We want the banking industry to be among the very lowest payors of effective tax rates." It is a cumulative impact of a series of preferences, not particularly enacted for that result. And it is at that point that I think Congress has to look seriously about whether in fact you really do want that result, whether that is a value judgment, that is beneficial to the country.

A second point I would make: If we have a corporate tax structure that holds out a corporate rate of 46 percent, and it turns out that the effective rate for one industry is 2.3 percent, that tremendously contributes to people's view that this is an inequitable, unfair tax system, particularly when they look at what they themselves pay.

So I think you have a second problem that this kind of activity causes, a feeling of a very, very inequitable tax system.

The third point I would make is that when we wind up on the corporate side with a whole series of industries paying vastly varying effective tax rates, the question is do we really want that? Is that a public policy judgment that those differences should be made? Or did we wind up that way?

It's where a system of preference after preference after preference takes you to, without ever making any value judgment that you wanted to get there. And in that context I think this kind of hearing and future hearings require the Congress to look at that and make the judgment.

So I didn't say and I don't say, "Repeal all of those preferences." I do say that given the very favorable treatment and the tax system that the banks appear to have, it is correct to be very carefully looking at this question and determining whether this is fair and equitable vis-a-vis individual taxpayers and other industries.

Senator **Chafee**. Well, I think you are right. I think it is of great value to look at this, and when you see a disparity within an industry or of industry versus industry we should consider it.

But when we grant the preferences around here, the preferences aren't to preserve the industry or the corporation; the preferences are directed toward what is the effect going to be on the individual. We don't give preferences as far as banks not having to pay interest or being able to borrow to invest in tax-exempt bonds; we do that because of the effect on the tax-exempt bonds, not looking at the industry.

However—yes?

Mr. **Kaplan**. Senator Chafee, I wanted to mention two things on that subject.

First, you asked earlier that the joint committee staff investigate the relationship between effective tax rates and charges to consumers. The studies that Tax Analysts have done are unique in the sense that they have been done over the past 9 years, not just for 1981, and show that banks' effective tax rates have been regularly the lowest of all industry groups, and on an absolute level, have been less than 10 percent throughout that period.

During that same period, of course, interest rates charged to consumers, which we might think of as the price to the ultimate purchaser, have varied widely, apparently without any relationship to corporate tax rates.

Senator **Chafee**. My time is up, but it is curious. I think Mr. Wertheimer's points are very good, but it is curious that with this low rates, these preferences and all, that people aren't rushing to invest in banks, but banks as investments, as a stock, have been a dog or close to it over the past 15 years.

Well, I wouldn't put them quite that low, but they have not been as good as some.

Thank you.

All right, go ahead.

Mr. **Kaplan**. I had one further point, and that is that all of these studies use 1981 rates. I think that is significant, because the changes wrought in 1982 have not been incorporated into the financial statements that we have been able to see.

I mention that point because of the discussion in Congress last year relating to the alternative minimum tax. This is relevant to the discussion of whether banking tax preferences ought to be repealed. While an alternative minimum tax doesn't repeal a tax preference, it certainly reduces its attractiveness. And of the various tax preferences enjoyed by financial institutions, there is only one such preference that is not subject to the alternative minimum tax, and that exception is the exemption of interest from municipal bonds. The principal tax incentive relating to leasing—namely, accelerated depreciation for property subject to a lease—is included, as well as the excess bad debt reserve additions. Both of the excess deductions, that is the tax deduction in excess of what actual experience would produce, under section 585 for banks and under section 593 for savings and loans, is already subject to this minimum tax.

Senator CHAFEE. Thank you very much.

Senator PRYOR. May I ask another question?

The CHAIRMAN. Sure.

Senator PRYOR. I might just ask each of you to answer yes or no. Do you feel that the banks should be taxed at the same rate, for example, as General Motors or Exxon or Montgomery Ward? In other words should we apply basically the same formula to the banks as we apply to those types of businesses?

Mr. KAPLAN. Our studies have never suggested that all corporations be taxed at the same rate, but rather that the problem of horizontal equity that you are describing is probably more significant for human taxpayers than it is for corporations vis-a-vis other corporations. When we have such widely varying effective rates, however, significant questions about the underlying tax provisions are appropriate.

There are economic concerns, though, about having differential tax rates, and I will let Dr. Fullerton respond to that.

Mr. FULLERTON. Well, the efficiency considerations I was discussing earlier would suggest that you would want to have the same rate on all industries.

In terms of the equity considerations, as I was saying, it is very difficult to get at any notion of equity among individuals by taxing corporations at all. High-income corporations can be held by low-income individuals, and very low-income corporations are often held by high-income individuals. So you just cannot get at what you want in the way of taxing high-income people by taxing corporations at all.

Senator PRYOR. Mr. Wertheimer.

Mr. WERTHEIMER. I would just say, without saying yes to equality, I would like to see something a lot more equitable and with a lot less disparity.

Senator PRYOR. Thank you.

The CHAIRMAN. Well, I know we have been primarily discussing banks, but I think there is also some question—I know Treasury has expressed a view on the credit unions and the statutory tax exemption they enjoy. Have you given any thought to that?

I cited a couple of examples of very large credit unions that are totally tax-exempt. And again, if we are looking at the whole picture, as we are, I'm not trying to single anyone out or to eliminate anyone from at least consideration. I think that's another area we should address.

Mr. **Wertheimer**. I don't have a position on that except to say that is absolutely correct. You pointed out earlier, if there are changed circumstances one has to look at it in a different context.

The **Chairman**. Mr. Fullerton, does your theory of equity suggest that Congress shouldn't make any changes in the Tax Code? Just leave all the tax breaks—since they all balance out in the market somehow?

Mr. **Fullerton**. In terms of equity, Senator, it would suggest that we never make any tax changes, because the redistributions that result are very capricious. However, in terms of efficiency, that is not the case. Efficiency would argue very strongly for equalizing tax rates on all business activities.

There are basically two ways to equalize tax rates on different industries. If you notice these tax disparities, one way to eliminate them would be to raise the taxation of banks. In light of some of the other things I have said, however, it would be better to lower the taxes on the other corporations instead. With a consumption tax, for example, a comprehensive consumption tax, then when people set aside savings, those savings would be deducted from the tax base. They could be used to invest in a bank or a business or any kind of business activity, and the return would then be taxed at the individual's correct marginal rate when withdrawn from the account in order to be consumed. Such a plan would get at the problem of taxing individuals equitably, because that tax base, the consumption tax base, could be applied to a schedule that is as progressive as you like. Separate business taxes are very complicated and are really unnecessary.

The **Chairman**. Right. I think the President hinted about that in Boston recently. [Laughter.]

I'm not quite clear what his message was, but——

Mr. Kaplan, could you explain briefly and in simple terms what it means when a corporation has a negative tax? And also, can individuals generally enjoy this unusual privilege? You know a lot of people out there would like to have some of that negative tax and don't know how to do it.

Mr. **Kaplan**. I quite agree. I'm afraid that the privilege of a negative tax rate is denied to humanoids; the best we can do is have negative income. [Laughter.]

And that is a very different situation from a negative tax rate. A negative tax rate indicates that the company, in computing its income for tax purposes, has a loss—that is, the accelerated depreciation, the investment tax credit, all of these particular deductions and credits actually exceed the company's taxable receipts.

I should point out that if the company is actually losing money, we do not consider that to be a negative tax rate, because we wouldn't expect such a company to be paying taxes to begin with. All of the companies included in the tax analysts' study with negative effective tax rates are companies that made money, at least in their reports to shareholders. So we are dealing not merely with a situation of financial income as reported to shareholders exceeding taxable income as reported to the IRS, but rather the most extreme example of that phenomenon: Income reported to shareholders is positive and income reported to the IRS is negative.

These negative tax rates flag the fact that we have a company that is making money but not paying any tax, creating instead a series of claims for tax refunds to be presented for up to 15 years.

The CHAIRMAN. Well, I want to thank the panel very much.

I would say to Mr. Wertheimer, I don't know what is happening on the floor but I understand they have moved to other amendments, so I assume we will renew the withholding discussion today or next week or next month.

But we appreciate any help you can give. It's rather a lonely battle out there right now.

Mr. WERTHEIMER. We will do what we can, Senator.

The CHAIRMAN. I understand the President did say this morning he would veto the jobs bill if the ABA succeeded in getting the repeal of withholding on the bill.

Our next witness happens to be from the ABA. [Laughter.]

Mr. John Garry. We are very pleased to have Mr. John Garry, senior vice president, Morgan Guaranty Trust Co., New York, N.Y., on behalf of the American Bankers Association, Washington, D.C.

Mr. GARRY. Thank you, Senator.

The CHAIRMAN. And I might say, Mr. Garry, your entire statement will be made a part of the record, and you can summarize or proceed in any way you wish.

[Mr. Garry's prepared statement follows:]

STATEMENT
OF
JOHN F. GARRY
on behalf of
THE AMERICAN BANKERS ASSOCIATION
TAXATION OF BANKS, SAVINGS AND LOANS, AND CREDIT UNIONS
before the
SENATE FINANCE COMMITTEE
UNITED STATES SENATE
WASHINGTON, D.C.
March 11, 1983

STATEMENT OF JOHN F. GARRY ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

I am John F. Garry, the Chairman of the Taxation Committee of the American Bankers Association. I am a Senior Vice President of the Morgan Guaranty Trust Company. The American Bankers Association is the national trade and professional association for America's Full Service Banks, The combined assets of its nearly 13,000 member banks represent approximately 95 percent of the industry's total assets. I would like to thank the committee for this opportunity to testify.

Taxation affects more than the balance sheet of a government.

In times past, however, governments operated on the assumption that immediate revenue was the sole factor involved in making decisions to tax.

We can only describe many of the consequences of such a policy as disastrous, especially in that they reflected a simple lack of foresight on the part of officials.

For example, a noted British historian points out that government policy-makers played a part in creating the terrible health conditions in the slums of England during the first half of the nineteenth century.

True, the tenement owners were reluctant to make improvements in their property.

However, he observes that the government reinforced this reluctance by taxing window glass. A generation of the English working class literally lived in the dark as a result.[1]

We have only anecdotal evidence - such as reports from special commissions and the works of Charles Dickens - to support the notion that this official short-sightedness resulted in misery if not illness.

Despite the lack of statistics, can we doubt that it did?

I hope that today we have a greater awareness that the effects of tax -- any tax -- are felt throughout our economy and society.

Now, as to the purpose of today's hearing, the American Bankers Association could not agree more readily that the Finance Committee and the Ways and Means Committee have a continuing oversight responsibility for the tax code. As you know, Mr. Chairman, many special provisions enacted recently have included termination dates, thereby almost compelling periodic reevaluation of the necessity and appropriateness of the provisions.[2]

There is no reason why the Congress should not periodically reexamine other provisions of the Internal Revenue Code of 1954 to test them for continued justification and utility. There should be no legitimate objection to thoughtful, even-handed reconsideration of the tax policy and public policy behind any provision of the Federal tax law. Temporary or transient changes in the political or economic environment should not be allowed, however, to influence the outcome of the reexamination process. I am confident that the Finance Committee will approach the subject matter of this hearing in a spirit of fairness and equity.

Effective Tax Rates

Let me turn first to the subject of effective tax rate studies. There is considerable disagreement over how effective tax rates should be calculated.[3] There is also concern that effective tax rate data may be misapplied or misused.[4] The more appropriate question is not what is the effective tax rate for banks, but whether banks are bearing their fair share of the burden of defraying the costs of government. The answer to that question necessarily involves a discussion of the contribution made by banks through excess earnings of the Federal Reserve system as well as the intermediation of rates paid by state and local governments on their borrowings.

While commercial banks are, in general, subject to taxation under the same rules applicable to other taxable corporations, there are many "special rules" applicable to banks scattered throughout the Internal Revenue Code of 1954,[5] the Internal Revenue regulations, revenue rulings interpreting and applying the Code, and court decisions involving controversies under this important and complex statute. Some of these "special rules" deny or limit benefits others confer benefits but most of them are needed simply to ensure that the general rules are properly applied to banking. In spite of all these "special provisions", an examination of the tax law for those features that are important in studies of effective tax rates reveals that, by and large, "special provisions" or "tax preferences" are not involved. Instead, as Chart I shows, the single most important factor in reducing the Federal income taxes paid by banks is the exemption from Federal income tax provided by section 103 of the code for interest paid by state and local governments on their obligations. In addition, another large component of the reduction for major institutions is the credit allowed by section 901 for foreign taxes imposed by other countries on income earned by the taxpayer in those countries. A third large component is the combined effect of the investment tax credit and depreciation deductions from equipment leasing operations. None of the tax reducing effects of these provisions of the Federal tax law is attributable to the enjoyment of a special provision by banks, except, arguably, to the extent that banks deduct interest on public deposits secured by pledged securities. Rather, they reflect the important role of banking in municipal financing and the costs of doing a banking business. On the other hand, there is special treatment when it comes to the loan loss reserve provision for banks and other financial institutions. Although this is not a major component of the reduction of Federal income taxes for most banks, we believe it is an important and justifiable "special provision" because it promotes safety and soundness in the banking system, a major goal of Federal policy.

I will address each of these subjects in turn, starting with effective tax rates.

EFFECTIVE TAX RATES

The subject of effective tax rates is difficult and complex. More important, even where there can be some agreement concerning methodology to facilitate comparisons, there is not necessarily any correlation between effective tax rates and fairness. As noted by the Joint Committee on Taxation in the study referenced in the press release announcing this hearing, "If generally accepted accounting principles and tax accounting rules were exactly the same, then all corporations would show an effective rate of tax equal to the statutory rate before credits. The differences between tax and financial accounting rules account for the variances in effective tax rates".[6]

The most important question, I believe, is whether commercial banking as an industry is bearing its fair share of the burden of defraying the costs of government. There are a number of ways to approach the question.

Using the method employed by the Joint Committee on Taxation in the study it prepared for Congressman Pease,[7] we have recalculated the effective tax rate to reflect better banking's contribution to the revenues by showing the result of including in the calculation the earnings on reserves provided to the Federal Reserve System, in a manner approved by the Securities and Exchange Commission for use in annual reports, and by showing a tax equivalent analysis of municipal bond income. See Chart I.

Under the Monetary Control Act, banks must post reserves with the Federal Reserve System on an interest-free basis in direct ratio to their transaction accounts and nonpersonal time deposits. The reserves held by the Federal Reserve System are then invested primarily in government securities. The Securities and Exchange Commission has approved a method for calculating the earnings attributable to the reserves posted by each bank and a format for disclosing this in annual financial statements.[8] Is this a tax? It is not cast as a tax, but as a regulatory requirement, but--because it directly generates revenue that is covered into the Treasury as miscellaneous receipts--it does represents a financial contribution by the banking industry to the revenues available to pay the direct costs of government. No other industry makes a parallel financial contribution. The effective tax rate for each institution in the Joint Committee study increases dramatically when these two factors, or either of them, is taken into account.

STATE AND LOCAL OBLIGATIONS

With certain exceptions not pertinent here, the Internal Revenue Code provides that interest earned on state and local obligations is exempt from Federal income tax. Commercial banks are the largest single component of the market for these obligations, historically comprising 50 to 60 percent of the market for these obligations. The tax-exempt income derived from investment in these assets is the largest single factor in reducing the nominal effective rate of Federal income tax for banks. This provision of the Internal Revenue Code is probably more important to banks than to any other type of corporation.

Banks purchase these obligations for a number of reasons that have little to do with the tax-exempt nature of the income from the investment. In many communities, particularly those with either no bond rating or an inferior rating, the banks of the community provide the only continuous, reliable source of financing for the local government. In other words, if the banks of the community would not agree to take a substantial portion of the obligations, where would they be sold--and at what price?

Bear in mind here also that a substantial portion of the tax-exempt obligations issued by state and local governments are not long term bonds but rather revenue anticipation notes and other short-term obligations used to cover temporary shortfalls of cash when payments, including municipal payrolls, become due before periodic tax receipts have been received.

In addition to purchasing a certain number of these tax-exempt obligations in order to meet their responsibilities as good corporate citizens of their communities, banks purchase state and local obligations to assure themselves liquidity and to meet pledging requirements for public desposits in excess of insurance limits.[9]

Approximately 35 states, and many local governments, require banks to secure public deposits in whole or in part by bonds issued by the state or local government involved, Federal securities, or similar high quality forms of collateral.[10]

Clearly, this is not a "special provision" or "tax preference" enjoyed by banks, but a reflection of the traditional role of commercial banking in providing financing to state and local governments. Although the exclusion from income of interest on state and local government obligations appears to have derived from early debates over the constitutional restrictions that might attach to the taxation of state and local governments by the Federal government,[11] the practical effect has been to make it possible for state and local governments to borrow money at rates lower than those payable on equivalent taxable obligations.

In 1980 the Internal Revenue Service issued Revenue Procedure 80-55, a ruling that would have terminated a longstanding administrative interpretation of a provision of the Internal Revenue Code that permits the deduction of interest paid on certain deposits secured by tax-exempt securities. Studies of the impact of that Revenue Procedure on state and local governments concluded that its implementation would "lead to added interest costs amounting to a present value of between $430 million to $2.15 billion on first-year sales of new state and local securities. Each year, of course, would add a new increment of interest costs."[12] The same study found that "an annual earnings loss to state and local governments of between $320 and $530 million" in interest on large public deposits would result if the revenue procedure were to be implemented.[13]

Not only does section 103 (which provides for the tax-exempt status of state and local obligations) not constitute a "special provision" or "tax preference" for banks, it confers a positive benefit on state and local governments through the intermediation of banks. Similarly, the so-called "bank exception" to section 265(2) (which denies the deduction of interest on indebtedness paid or incurred to purchase or carry tax-exempt obligations), permits banks to carry out their role as financial depositories of public funds in compliance with the requirements of state laws requiring collateral for large public deposits in an economically efficient manner.

As you can see from Chart II, investment in tax-exempt obligations has been a factor of decreasing importance in bank taxation for several years. The rate of decline in bank purchases of these obligations is even greater than indicated by the chart because for many of the decline years, the yields on tax-exempt obligations were increasing.

This decrease in bank investment in tax-exempt obligations is, among other things, a consequence of changes afoot in the financial marketplace. For example, a leading bank securities firm recently published an analysis showing that, as interest expense increases, "the positive effect on reported IBST (income before securities transactions) from tax-exempt investments increases as long as the bank has sufficient taxable income or is able to carry-back. However, if the bank finds itself in a carry-forward position the effect on IBST turns negative."[14] The article noted that "The problem stems solely from the absolute level of the cost of funds; regardless of the yield." For this reason, many banks have been slowing their purchases of tax-exempt obligations. With continuing deregulation of the financial marketplace, the aggregate cost of funds to commercial banks is likely to continue to increase. As it does, the importance of tax-exempt investments may well continue to decline in overall financial and tax planning.

It should be noted also that under new section 291 of the Code, enacted as a part of the Tax Equity and Fiscal Responsibility Act of 1982, a portion of the deduction for interest expense for banks and certain other financial institutions will be disallowed in the future to the extent that the bond portfolio reflects post-1982 acquisitions of tax-exempt obligations. This will further diminish the attractiveness of tax-exempt obligations for commercial banks. This will be reflected in the financial markets as higher yields are required in order to offset the tax penalty from new purchases of tax-exempt obligations.

In summary, the single largest factor in reducing the Federal income taxes otherwise payable by commercial banks has been investment in tax-exempt state and local obligations. Since commercial banks have made up 50 to 60 percent of the market for these obligations, the tax exemption not only lowers the Federal income taxes banks pay but also has an impact on the rates state and local governments must pay. Investors, including commercial banks, accept a lower yield on these obligations because of the tax-exempt nature of the income. Even without any erosion of the tax-exempt status of these obligations, commercial banks have begun to cut back their purchases over the past few years. In part this reduction is attributable to the impact of lower than taxable yields on financial planning in an environment in which the overall cost of funds to financial institutions is increasing.

Although as a banker I understand the importance of controlling and ultimately reducing the Federal deficit, I believe that there are serious and important public policy considerations involved with any modification of the tax treatment of state and local obligations, either directly or indirectly through modification of the tax treatment of commercial banks with respect to investment in tax-exempt obligations. Because of market forces and recent tax changes, the bank market for municipals appears to be shrinking. Any policy change that exacerbates this trend may have adverse consequences for communities all across this nation.

LEASING

Equipment and major asset leasing is a form of asset based financing. Financial institutions such as insurance companies, commercial banks, and finance subsidiaries of manufacturing companies have played a significant role as intermediaries in these transactions. These transactions may or may not be leveraged. If the transaction is a leverage lease, the owner of the leased asset will have borrowed part of the purchase price. In virtually every case this borrowing will not exceed 80% of the value of the asset. Such borrowing is normally secured by a lien against the asset itself as well as an assignment of the rents from the lessee.

In order to receive a favorable ruling from the IRS, the taxpayer must demonstrate that there will be income from the property independent of tax benefits.[15] Although the rule of Rev. Proc. 75-21 is a ruling standard only, a similar concept has been followed by the courts.[16] Consequently, it is necessary for lessors to demonstrate that there is a positive yield on the transaction without taking tax benefits into account in most transactions. This point should not, however, be overstated. The availability of tax benefits to the lessor are central to the transaction from both the lessor's and lessee's viewpoint.

The economics of tax oriented equipment leasing transactions are such that the bulk of tax benefits derived by the lessor in the form of investment tax credits and accelerated depreciation or ACRS deductions are immediately passed on to the lessee in the form of reduced rental payments. This is of particular importance to the capital intensive transportation industries.

There is no question that without such tax benefits, the yield on any given transaction would be so low as to be unmarketable. Accordingly, any legislative change which reduces or eliminates the economic value of those tax benefits will effectively remove leasing as an important source of financing to capital intensive industries.

For a variety of reasons, over the past three to five years many major banks have substantially reduced the volume of leasing activity. In order to utilize most thoroughly the tax benefits associated with equipment leasing, the lessor must have a sizeable portion of taxable income available to it. Major banks have not enjoyed such a large taxable income pool that would permit the tax benefits associated with leasing to be fully utilized. In addition, leasing transactions, whether leveraged or not, require a hefty initial outlay of capital. Depending on the size of the transaction, this capital may be committed to the transaction for extended periods of time. For example, leases of wide-bodied aircraft typically have a term of fifteen to eighteen years. The committment of capital for so long a period during times of great interest rate volatility may not be attractive.

In summary, equipment and major asset leasing is a financing device through which businesses in need of plant and equipment may obtain the use of these capital items without suffering the high initial cost of purchasing them. To this end, banks and other financial middlemen put capital and user together. In performing this service the financial institution may act as lender, investor, broker, or advisor to an investor. Whatever the role of the financial institution, the availability of tax benefits is usually a basis on which a lease can be economically distinguished from a loan or conditional sale.

MUNICIPAL LEASING

Municipal leasing is a financial transaction in which the "lessor" provides capital to a local or municipal "lessee". The lessee is a state or municipality (or an agency there of) authorized to issue debt carrying interest exempt from federal tax. Unlike the equipment leasing situations, the "lessor" does not treat the transaction as a lease for Federal income tax purposes. The "lessor" does not claim either cost recovery allowances or the investment tax credit on its tax return. In addition the "lessor" takes pains to assure that the transaction will not withstand scrutiny as a lease under established precedents. Hence the lessor may not have the typical 20% investment in the asset, the term of the lease may be for the entire useful life of the asset, and the "lessor" will treat a portion of the rents paid by the "lessee" as tax exempt interest pursuant to section 103.

Municipal leasing is best viewed as merely a specific type of tax exempt financing. For this reason the typical financial motivation for engaging in this type of financing is to obtain tax exempt interest. The lessee, on the other hand, perceives the transaction as advantageous for its "off balance sheet" quality. Many local governments and publicly owned corporations and associations are limited by law in the amount of debt which they can issue. In order to satisfy their capital requirements, these entities may enter into a transaction which qualifies as a "lease" under local law principles. This device may permit the local government to avoid its limits on borrowing while, at the same time, allow it to obtain the required capital. Thus, the "lessee" will treat the transaction as "lease" on it books for local law purposes and the "lessor" will treat the same transaction as a loan or conditional sale for Federal income tax purposes.

While these transactions have an elegant simplicity, they are not in widespread usage. In some cases, the same laws which limit municipal borrowing will affect the municipalities' ability to lease as well. In other cases the credit considerations which underlie the local laws limiting the amount of debt will deter the financial institution from extending credit. Finally, the tax experience of major banks over the recent period has been that there is a need for taxable as opposed to tax exempt income.

Since, as was stated previously, municipal leasing is best viewed against the backdrop of all tax exempt financing, financial institutions will evaluate municipal leasing as an investment in a tax exempt item. In many cases financial instititions will enter into such transactions for reasons wholly independent of the return on assets. Banks must also "live" in the communities where they transact business. As a practical matter, they buy a certain number of tickets to the local policeman's ball. They sponsor a little league team. If a new fire engine is required for the local volunteer fire department, they are likely to be called on to consider a municipal leasing transaction.

In considering the role of this type of financial transaction under the Internal Revenue laws it is best to analyze municipal leasing as another variety of tax exempt financing. Revenue measures which affect section 103 are likely to affect municipal leasing transactions as well. Depending on what decisions are ultimately made, it is likely that any changes which erode the tax benefits associated with these transactions will either reduce the availability of capital to municipalities or increase its cost. In this respect, this is a point on which we need to be very clear. The financial needs of state and local government are not dictated by the banks. Those requirements will exist regardless of whether financial institutions are able to participate in these loans. To the extent the banks are not able to join in these transactions, to the extent they are dissuaded from them, local government will have to find other sources of capital.

THE FOREIGN TAX CREDIT

Former Assistant Secretary for Tax Policy Donald C. Lubick stated the case for the foreign tax credit with elegant simplicity. "...The foreign tax credit recognizes the inequity that would result if a U.S. taxpayer paid income tax both to a foreign government and to the U.S. on the same income. Such international double taxation would severely impede foreign investments by U.S. taxpayers, and in some cases would make such investments prohibitively expensive."[17]

Like other U.S. taxpayers, banks that engage in international activities are subject to foreign taxes on income produced from such activities and are also subject to U.S. income tax on the same income. The foreign tax credit is the tax mechanism by which relief is obtained from the double taxation that would otherwise occur. As a factor in the reduction of Federal income taxes paid by commercial banks, the foreign tax credit closely parallels the growth in foreign lending that occured during the early 1970s. Its impact is, of course, restricted to major financial institutions because the rapid growth in foreign operations over the period was concentrated in the largest banking organizations.[18]

Foreign lending has become increasingly competitive in recent years, and U.S. banks may be losing the competition. After undertaking almost 40 percent of net new lending in 1976 and 1977, the share of new lending by U.S. banks dropped to 20 percent in 1978 and turned negative in the first six months of 1979 as repayments exceeded gross new lending.[19] Foreign banks, especially those from strong-currency countries, are a major factor in dollar lending abroad. Up to now, U.S. banks have welcomed the increased competition--although admittedly with mixed feelings--as a sign of the health of the international banking system. As increased competition has narrowed profit margins for foreign lending, the foreign tax credit has become increasingly significant. In fact, if the foreign tax credit were not available, U.S. banks would have to increase interest charges in order to maintain an adequate return. Competition from other banks will not permit such pricing. The increased tax cost would put U.S. banks at a competitive disadvantage with foreign banks, whose costs would not be similarly increased, and might well force U.S. banks out of important overseas markets. Because of the role foreign loans play in financing the sales of

United States commodities and products abroad, *a reduction in the availability or utility of the foreign tax credit to commercial banks could not fail to have an adverse impact on U.S. trade, on our balance of payments, and even on domestic employment*.

Although statistics vary somewhat, about 20% of all goods produced in the U.S. today are exported. That figure rises to about 40% in agriculture.

Exports are an important factor in generating jobs in the United States. As a percent of the labor force, more than 10% of U.S. jobs rely on exports. For agriculture, the impact that exports have had on employment is much larger. Almost 24% of all agricultural jobs depend on exports.

Even so distinguished a critic of many aspects of Federal tax policy as Stanley Surrey recently commented that "Revision of the foreign tax credit lies more in the technical field, since the problem is one of proper structure for a credit whose basic use is to eliminate double taxation."[20]

Here, again, one is dealing not with "special provisions" or "tax preferences" but with a basic structural component of our Federal income tax system. Substantial modifications in the foreign tax credit might result in a reduction of its significance to tax and financial planning at major banks, but it would surely have an adverse impact on all U.S. taxpayers whose exports of goods or services are financed indirectly by U.S. banks through foreign lending.

RESERVES FOR LOAN LOSSES

Prior to the Tax Reform Act of 1969, the method for computing additions to the reserve for loan losses for commercial banks was determined by administrative rulings. In 1965, under Revenue Ruling 65-92, the Internal Revenue Service set out a uniform percentage of 2.4 percent of outstanding uninsured loans for computing the addition to the reserve for loan losses for banks.

The Tax Reform Act of 1969 enacted section 585 of the Internal Revenue Code. This section provided new statutory rules for computing a reasonable addition to the reserve. For years prior to 1987 a bank is allowed to compute its reserve addition using either the percentage method or the experience method. Under the percentage method the maximum allowable percentage dropped from 2.4 percent to 1.8 percent for years prior to 1976, to 1.2 percent for years beginnning after 1975 and to .06 percent for years 1982 through 1987. The Economic Recovery Tax Act of 1981 amended section 585 to provide that the maximum allowable percentage for 1982 would be 1 percent. For taxable years beginning after 1987 a bank will be required to compute the addition to the reserve on the basis of its loan loss experience for the current year and the preceding five years.

In addition, the difference between the amount computed and deducted under the percentage method and the amount computed as if the bank had always been using the experience method is treated as a tax preference item for purposes of the minimum tax under section 56 of the Internal Revenue. Code. This amount is also treated as a tax preference item for purposes of section 291 which was established by the Tax Equity and Fiscal Responsibility Act of 1982. Section 291 provides that the allowable loan loss deduction be reduced by 15 percent of the loan loss tax preference amount.

While the level of loan losses for the banking industry as a whole amounted to approximately one-half of the maximum rate of allowable reserve additions provided by section 585 for 1976 through 1981, many banks experienced losses equal to or greater than the 1.2 percent level in effect for 1981. It should be noted that, particularly in light of loan losses experienced during the current economic decline, bank regulatory agencies are encouraging banks to increase their loan loss provisions in order to diminish the risk of severe economic reversals from the cumulative effects of non-performing loans due to current business failures. In fact the Comptroller of the Currency and the Chairman of the Federal Deposit Insurance Corporation supported legislation in the 97th Congress which would have kept the allowable percentage at the 1 percent level on the basis that a reduced rate would discourage banks from maintaining adequate loan loss reserves.[21]

Section 585 did establish a "special provision" for banks. However the maintenance of adequate loan loss reserves is not tax motivated; it is necessary to the preservation of a sound banking system.

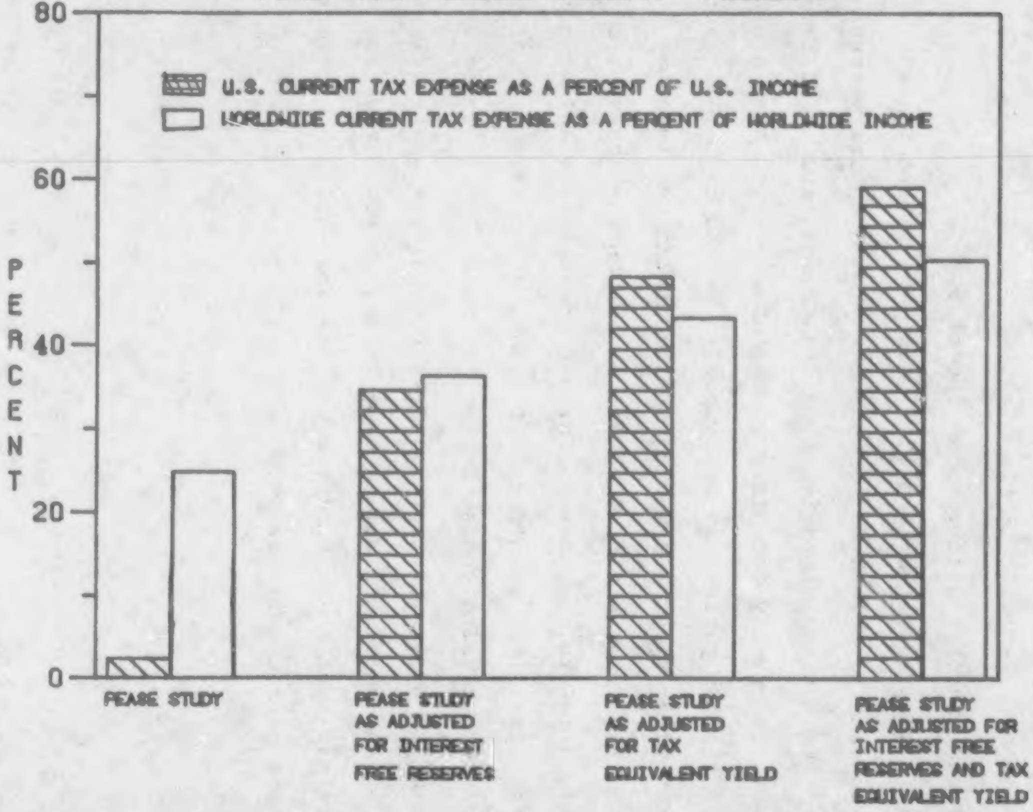
CONCLUSION

I appreciate this opportunity to review with you those provisions of the Internal Revenue Code that reduce significantly the Federal income tax paid by commercial banks. As you can see, the effective tax rate for commercial banks is not a result of special provisions and tax preferences so much as it is simply the straightforward operation of basic structural components of our tax law. Due to time limitations imposed on the Joint Committee on Taxation in the preparation of the pamphlet published for use at this hearing, it was not possible for the staff to take a statistically sound survey of commercial banks grouped by asset size, organizational structure, or product lines. Each of those factors, we believe, can affect not only the Federal income taxes paid by an organization but also will change the "mix" of tax attributes that form the constituent elements of their tax and financial planning.

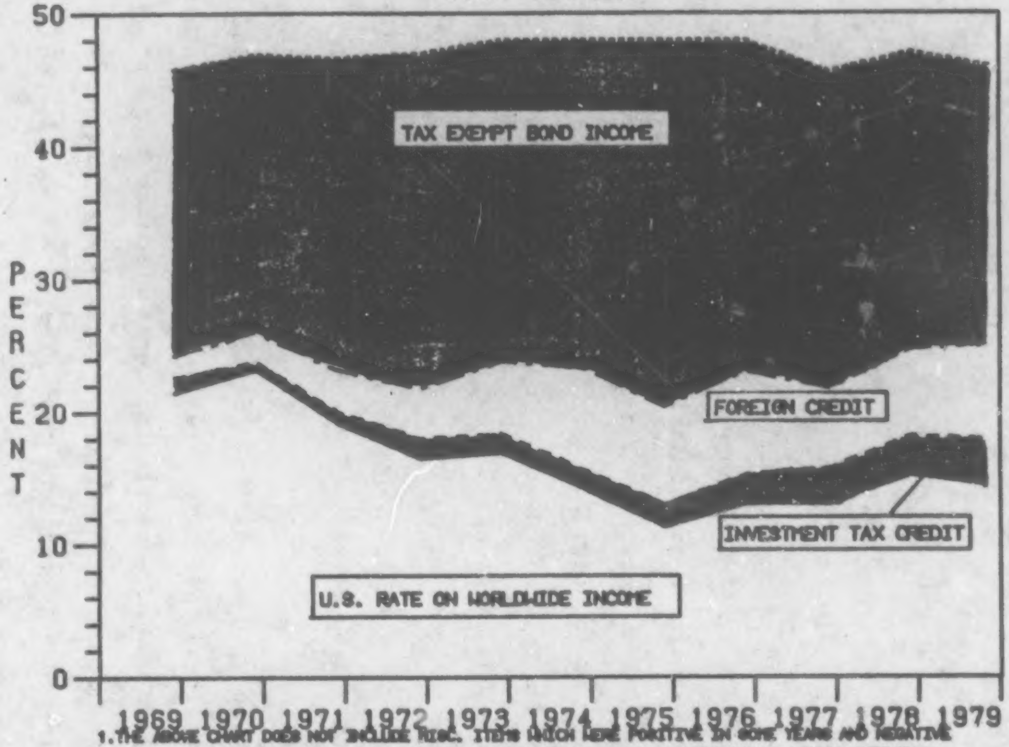
We believe that this is an important inquiry and a serious subject. We are concerned that the Committee may draw inferences from the study that are not justified. It is unfair and inaccurate, particularly for purposes of assessing the continued justification of certain tax rules, to assume that commercial banking is a monolith of 14,500 identical units. Rather, the banking system is more like a living body consisting of interacting cells similar in structure, but differing in function.

Tax rules that are of significant interest and substantial effect for one bank may be completely irrelevant to the tax and financial planning of another. An attempt to make tax policy decisions based only upon industry averages or the tax picture of large publicly-held banks, without taking into account the diversity within the industry and the functions affected or served by particular rules of tax law, is likely to have unintended competitive and economic effects. This would result from the uneven impact of a revenue-gaining change in the law on different commercial banks. Most important, many of the changes that would raise revenue would ultimately have their greatest impact on one or more public or economic sectors and would thus affect not only banking but everybody.

CHART 1 - ADJUSTMENT OF EFFECTIVE TAX RATE TO REFLECT FEDERAL RESERVE EARNINGS AND TAX EQUIVALENT YIELDS



SOURCES OF REDUCTION IN FEDERAL TAX RATES



1. THE ABOVE CHART DOES NOT INCLUDE MISC. ITEMS WHICH WERE POSITIVE IN SOME YEARS AND NEGATIVE IN OTHERS. IN YEARS 1974 AND 1976 TOTALS WITH MISC. ITEMS INCLUDED WOULD ADD TO MORE THAN STATUTORY TAX RATE DUE TO ADDITIONAL FACTORS SUCH AS REVERSAL OF TIMING DIFFERENCES,RECAPTURES,ETC.

* THE MAXIMUM STATUTORY RATE WAS 48% FOR THE 1969-1978 PERIOD AND 46% FOR 1979.

FOOTNOTES

1. "The Treatment of Capitalism by Historians", Ashton, T.S., in Capitalism and the Historians, Hayek (ed.), University of Chicago Press, 1954, p. 49.

2. This has been particularly true with respect to provisions intended to stimulate certain investments, such as the energy credits allowable under section 38 of the Internal Revenue Code of 1954. Under that section, taxpayers are entitled to claim an investment tax credit of from 10 to 15 percent for investment during periods beginning as early as October 1, 1978, and ending between 1979 and 1985 for investment in solar, wind, or geothermal property, ocean thermal property, qualified hydroelectric generating property, qualified intercity buses, or biomass property. This technique of establishing termination or "sunset" dates has become increasingly common whenever new sections are added to the Code that provide a deduction or credit.

3. See, e.g., "The Realities of Bank Taxation", Lamp, Walter, Tax Notes, July 19, 1982, p. 179; "Are Implicit Taxes Taxes?", Field, Tom; Kaplan, Richard; and Starcher, Mark, Tax Notes, July 19, 1982, p. 181; Letters and response, Tax Notes, August 9, 1982, p. 558; "Some Issues in the Calculation and Uses of Effective Corporate Income Tax Rates", Horst, Thomas,

Tax Notes, November 1, 1982, p. 347.

4. Horst, loc. cit.

5. The term "bank" appears in at least 95 different sections of the Internal Revenue Code of 1954.

6. _Cong. Rec._ (daily ed.) December 20, 1982, p. H10547.

7. Ibid, pp. H10545- H10549.

8. See, e.g., Chemical New York Corporation Annual Report 1982.

9. Commercial banks are heavy buyers of municipal bonds when their loan demand is relatively soft and credit is readily available, beginning usually when the economy is slack and interest rates are low, and continuing well into the next business cycle expansion. Demand for business loans generally gathers strength late in a business cycle. As loan demand picks up steam and credit generally tightens, the banks slow their buying of municipal bonds and some liquidate portions of their holdings. This pattern has been followed fairly consistently in the post World War II period.

Commercial banks usually invest in municipal securities of short and medium-term maturities to assure themselves liquidity. Commercial banks also own municipal bonds to pledge as collateral for public deposits. In addition, municipal bonds can be used for collateral at the discount window of the Federal Reserve. _Fundamentals of Municipal Bonds_, Public

Securities Association, New York (1981), pages 96, 97.

10. American Bankers Association, State Banking Law Service 1980 ed., pp. 63-72. "An Analysis of the Impact of RP 80-55 on the Tax-Exempt Bond Market", Ronald Forbes and Paul Leonard (School of Finance, State University of New York at Albany) January 30, 1981.
11. Mertens Law of Federal Income Tax secs. 8.13 - 8.17.
12. "Estimating the Impact of IRS Revenue Procedure 80-55 on State and Local Short-term Investment and Borrowing", Petersen, John E., (Municipal Finance Officers Association) February 13, 1981, p. 18.
13. Ibid., p.12.
14. "A Taxing Problem for Banks", Puglisi, Kenneth F., 1 Keefe Bankreview 2, Keefe, Bruyette & Woods, Inc., January 18, 1982.
15. Rev. Proc. 75-21, 1975-1 C.B. 715.
16. See Hilton v. Commissioner, 671 F. 2d 316 (9th Cir., 1982).
17. Attachment to July 24, 1979, letter from Treasury Assistant Secretary Donald C. Lubick to Representative Al Ullman, Chairman of the Ways and Means Committee, U.S. House of Representatives.
18. "Changes in Major Sources of Tax Savings for Banking Organizations: 1969-1977", Hanweck, Gerald A. and Kilcollin, Rick, Research Papers in Banking and Financial Economics, Board of Governors of the Federal Reserve System, p. 9.

19. Taxation of International Income of Commercial Banks, Taxecon Associates, (1981), p. 2.

20. "Our Troubled Tax Policy: False Routes and Proper Paths to Change", Surrey, Stanley S., Tax Analysts Special Report, 1981, p. 18.

21. Letter of July 27, 1982, from Comptroller of the Currency C.T. Conover to Congressman Bill Frenzel; letter of July 23, 1982, from Chairman of the Federal Deposit Insurance Corporation William M. Isaac to Congressman Bill Frenzel.

STATEMENT OF JOHN F. GARRY, SENIOR VICE PRESIDENT, MORGAN GUARANTY TRUST CO., NEW YORK, N.Y., ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION, WASHINGTON, D.C.

Mr. GARRY. Since you have introduced me, I don't have to do that myself.

The American Bankers Association, the organization on whose behalf I am appearing today, is the national trade and professional association for America's full-service banks. The combined assets of its nearly 13,000 members represents approximately 95 percent of the industry's total assets.

I would like again to thank the committee for this opportunity to testify.

There can be no legitimate objection to thoughtful, even-handed reconsideration of the tax policy and public policy behind any provision of the Federal tax law. I am confident that the Finance Committee will approach this subject matter in a spirit of fairness and equity.

Now, if I may, I would like to turn to the subject of effective tax rates.

It has been widely publicized and frequently spoken about here this morning that the 20 banks discussed in the Joint Committee study have an effective rate of U.S. tax on U.S. income of only 2.7 percent.

We are concerned that this information is misleading because it fails to reflect the real financial contribution made by the banking community in the support of Government.

If one takes into account the excess earnings of the Federal Reserve System from the interest-free deposits provided by banks, and the costs to the banks of State and local financing through the reduced yields on these tax-exempt obligations, then the equivalent effective tax burden for these 20 banks is 59 percent.

As pointed out by the joint committee, and I quote:

> One deficiency in the effective-tax-rate concept is that it does not distinguish between the income tax burden imposed directly upon a taxpayer—in the case of banks a relatively modest burden in 1981—and the ultimate economic burden that the income tax places on a person. The economic burden of the income tax on banks is considerably higher than the actual tax they owe.

Now, putting aside effective tax rates, we believe that it is more important to look at the major components that go into the computation of the Federal tax liability of banks.

As the chart on page 25 of our prepared statement shows, the single most important factor in reducing Federal income taxes paid by banks is the exemption provided by the code in section 103 for interest paid by State and local governments on their obligations. This provision historically has permitted State and local governments to borrow money significantly below market rates.

Another component of the reduction for banking institutions as well as for other corporations is the credit allowed by section 33 for foreign taxes paid or imposed by other countries on the income earned in those other countries. This credit operates to avoid double taxation of income earned by U.S. taxpayers in foreign jurisdictions, and it thereby encourages the export of American goods and services.

A third component is the combined effect of investment tax credits and depreciation deductions from leasing transactions.

Equipment leasing provides an alternative method of financing for American business.

None of the tax-reducing effects of these provisions of the Federal law is attributable to the enjoyment of a special provision for banks. Instead, they merely reflect the important role of banking in municipal financing and acting as a financial intermediary.

Finally, I would like to spend a moment discussing the loan-loss provisions for banks. We do not view the maintenance of adequate loan-loss reserves as tax motivated. Rather, we believe that the deduction for loan-loss reserves is an important and justifiable provision because it promotes the safety and soundness of the banking system, a major goal of Federal policy.

As a matter of fact, we believe that the 1-percent level that was authorized by Congress last year should remain a permanent part of the law.

In closing, I would like to compliment the joint committee staff on their study. The tax treatment of banking is a complex subject even for tax professionals.

Although I have not had time to review the study in detail, it appears they did an excellent job in a very short period of time.

Thank you.

The **Chairman**. Senator Long.

Senator **Long**. I am glad to hear your statement of your analysis of your tax problem. It took a long time to get to it, and we only have two Senators left here now, one on each side of the aisle here, but I'm glad we did have the opportunity at last to hear what your analysis was.

Now, Bill Simon was Secretary of the Treasury in a Republican administration. I think he did a fine job, and I think he is a very fine, noble American. I didn't always agree with him, but I respect him as a great American citizen, and I think he is a patriot.

He once sold, I think, some tax-exempt bonds, and he said when asked before this committee what his view was about these tax-exempt bonds, he said, "They have already been taxed." And the point that he had in mind was that when you buy those tax-exempt bonds you are getting a much lower rate of return.

I take it that you are saying that in effect you have paid to the local government the difference between what you would have got if you bought Federal bonds compared to what you are going to get by buying State and local bonds.

Mr. **Garry**. That is correct, Senator.

Senator **Long**. So, in looking at it from that point of view, it is your position that you are actually paying 59 percent in taxes rather than 2½ percent.

Mr. **Garry**. Well, we don't believe that showing of 2½ percent in the newspaper is taking into account the full Federal and State tax burden that the banking community is subject to. And when we take into account the computation that was used by the joint committee in developing the 2.7-percent rate, when we adjust that for the equivalent of this tax-exempt interest and the equivalent interest on the reserves we keep at the Federal Reserve Bank, you make those two adjustments, and we would allow that an effective tax burden for those 20 banks would be in the neighborhood of 59 percent

Senator LONG. Well, it seems to me as though it is somewhat parallel to a question I raised earlier. You might have heard this when Mr. Metzenbaum was testifying about the taxes on oil. They hit you with a 70-percent tax on your income. Now, they call that a windfall profits tax, but you pay it whether you are making a profit or not.

Then they hit you with, let's say, a 10-percent tax on gross and call that a severance tax. They will let you deduct that before you pay your income tax. But mind you, in view of the fact that the price is fixed by the world market price, you have to pay all that before you have anything left on which to pay the remainder. Then they proceed to say that you are only paying 2½ percent income tax—because they have already taken most of your income. They have got one-half of it already. So what they have got left after you deduct for your other expenses, that doesn't leave much to tax.

Now, when you fail to take those things into account it can give a pretty misleading impression. The Government already took more than half; but with the tax they put on what's left, it sounds as though you didn't pay much tax.

Now let me ask you: Are you ready to have this analysis of yours examined by those who might not agree with you? By those on the other side—Mr. Wertheimer and his group, or anybody who would like to contend that you are not paying your share of taxes?

Mr. GARRY. Certainly we will defend this chart we have Senator. Sure.

Senator LONG. Thank you very much.

The CHAIRMAN. Mr. Garry, I appreciate your coming very much, and I want to say first of all I hope you appreciate the spirit of the hearings. [Laughter.]

I mean, there has been some misconception about why you are here. In fact, maybe you didn't volunteer. I assume Mr. Hastings is probably busy on a talk show somewhere and couldn't make it. [Laughter.]

But I would just say that it seems to us that we are in the process of looking at financial institutions, life insurance, casualty companies, many others, and I would hope that the banks understand that we are not picking out one group called financial institutions. In fact, we also include savings and loans and credit unions.

Does the ABA have a position on the tax-exempt status of credit unions?

Mr. GARRY. Not that I am familiar with, Senator.

The CHAIRMAN. You don't have a position either way?

Mr. GARRY. I haven't heard the association take a position.

The CHAIRMAN. Well, I know the Reagan Treasury like the Carter Treasury before it has urged repeal of the credit union exemption, and I'm not suggesting what the committee may or may not do; but at least we feel it is an area we should look at.

Your testimony directly addresses the use of tax-exempt bonds to reduce the tax liability of banks. Unfortunately, however, you failed to quantify that effect, and I would like to call your attention to the joint committee staff study which does attempt to quantify this effect and ask your reaction to it.

The staff of the Joint Tax Committee argues that less than half the benefit of tax exemptions go to the State and local governments. Now, are you prepared or can you refute that joint committee conclusion that banks receive a tremendous windfall? If you are not prepared now you can submit it in writing, or whatever, you know.

Mr. GARRY. Well, I briefly reviewed what the staff wrote on that area, and it is interesting that they determined that the banks don't benefit as much from short-term obligations as they do from long-term obligations.

But I can remember last year when we published some figures about the size of the portfolio that we had in our bank. We had some long-term bonds that were not terribly tax efficient that were yielding 4 and 5 percent at a time when the prime rate was up around 20 percent. So I think, although the joint committee refers to both long and short term, I think it is critical to determine what those analyses would be under varying rate structures.

The CHAIRMAN. The official spokesmen of the ABA have taken the official position that if Congress is concerned with the low tax rates paid by big banks we ought to repeal the foreign tax credit.

Doesn't the recent bad experience with foreign loans demonstrate that we do not need any more incentives to make foreign loans? Or should we act on ABA's advice and repeal the foreign tax credit?

Mr. GARRY. This is the American Bankers Association that recommended repeal?

The CHAIRMAN. Yes, Mr. Hastings.

Mr. GARRY. I haven't made myself clear, then. [Laughter.]

The CHAIRMAN. Well, Mr. Hastings. I think he has some role with the ABA. But maybe that is not a fair question.

Mr. GARRY. I would not favor repeal of the foreign tax credit, Senator. I believe that it is very closely related to the export of American goods and services, and the reason that we incur foreign taxes is not to incur them just because we have nothing else to do; we do that kind of business because it encourages the customers we have here domestically to export their goods.

The CHAIRMAN. Now, your theory is that banks pay an implicit tax since they lose the opportunity of making profits on their reserves.

As you know, many banks earn unusually high profits on passbook savings because of Federal laws keeping passbook rates low. Is this benefit for banks an implicit subsidy or implicit negative tax under your theory? Or should we raise the passbook rates?

Mr. GARRY. I would think, in my own opinion, that deregulation of interest rates should occur over a period of time. I think that the Congress has already made that decision and put it in the hands of the Depositiory Institutions Deregulation Committee to see that that takes place.

If you are asking me would I encourage an acceleration of that on passbook savings, I am just not qualified to answer that question, Senator.

The CHAIRMAN. Well, I don't want to get into withholding, but it has been raised this morning. I again assure the witness that we didn't plan on it being an amendment on the floor at the time of this hearing, but that's the way it is. And as I understand, some banks support withholding and some banks oppose it.

What about your bank? What is the position of your bank?

Mr. **Garry**. Well, all I can say, Senator, is that when the law was passed I went back to our bank and told them what it was we had to do in order to comply with the law.

I can tell you that there were an awful lot of unhappy people in our systems area that had a lot of projects that were all scheduled out. They were told we had to postpone them and put them off. A lot of people were upset, and they told me it was going to cost a substantial amount of money.

The **Chairman**. How much does it cost?

Mr. **Garry**. We haven't actually set down—I have been asked that question before, Senator. We have not asked our people to sit down and figure out how much this is going to cost. We felt it was more important—we had to get it done regardless of the cost.

Now, if it is of interest to people, we can subsequently do a cost analysis of what it was to have this system installed.

The **Chairman**. I don't know of any official interest in it. I understand that some banks indicate it is not as costly as they felt it would be. Others have indicated it is more costly. And the only point is that there are provisions for a float, as you know, and we have been urging the Treasury Secretary that if there are real concerns on withholding then they should be addressed. I thought that is what the Treasury was trying to address about 10 days ago when they announced seven changes on original discounts, year end withholding, a number of other provisions.

And I know the ABA position—at least I assume the official position is that they still support repeal of that provision. Is that correct?

Mr. **Garry**. That's what I read in the newspapers, sir, yes.

The **Chairman**. Would you like to take some mail home with you? [Laughter.]

Has your mail picked up in your bank as much as ours has?

Mr. **Garry**. I don't believe so, Senator.

The **Chairman**. You are sending it out—that's right. [Laughter.]

Mr. **Garry**. I don't think we have sent any letters out.

The **Chairman**. Well, I don't want to quarrel with any one bank, because I think there is a difference of opinion. I don't suggest that anyone must like withholding, but do you see anything really unfair about tax compliance? I mean, is there something wrong with asking people who haven't paid their taxes to do so before this committee sets out to raise anyone else's taxes?

Mr. **Garry**. Senator, I have never come across a representative from any bank who was not in favor of total compliance with an individual's tax liability.

I think maybe the disagreement is, how do you get to that point? And I think that the banking community felt that there were probably somewhat different ways that might be less inconvenient to the public and more efficient to the banking system and to the IRS through improved reporting systems.

It seems to me that if there is a tax cheat out there who is not paying tax on his interest, if you take 10 percent away from him that doesn't mean he is going to report it; he's still getting away with $90 free. Now, maybe he should be paying 40 cents on the dollar of taxes.

It seems to me that with an efficient system of matching and you get that fellow's tax return and get the 1099 of the interest, and you put it together in a computer, I think you could end up with more tax.

The CHAIRMAN. Except we are told again that this is not a hearing on withholding. But I don't get to talk to many bankers these days. [Laughter.]

Mr. GARRY. I'll be here as long as you would like. [Laughter.]

The CHAIRMAN. I'm glad you are speaking to me.

But we are told by IRS—and again, we have had Mr. Egger up here—I have, privately—in the last 2 weeks to see if there are some real concerns that should be addressed. This is not a game, and it's not a battle between the banks and the Congress or whatever.

I said, "Why can't we do it through more reporting?" And, "What is the discrepancies on 1099's?" On interest alone we are told about 13 million 1099's are improperly filled out; on dividends I think the figure is 5–6 million; 20 million American taxpayers fail to report all or part of their interest and dividend income. They suggest it is just not possible through that system.

Now, there may be a better system, and I would hope, without any question, if in fact there is a better way to do it, then certainly we would like to discuss that with the American Bankers Association; but we are told that's what the Kasten amendment does, and the revenue increase would be about $50 million rather than around $4 billion a year when this is fully effective. Now, that is not compliance.

Again, like Senator Long, I've been on both sides of this issue; I voted with him in 1976 for withholding. I can't convince him to vote with me now, but things have changed.

If in fact there is anything we could suggest to the American Bankers Association, if they really want to try to work it out, we are available. But otherwise we are just going to have to do the best we can. There are people on both sides, and I don't quarrel with those on the other side; I'm just going to do what I can to prevent repeal of interest and dividend withholding. It's not a new tax—you understand that.

Mr. GARRY. Yes, sir, I do.

The CHAIRMAN. Seeing the ads, I wonder. [Laughter.]

You know, it's been played as a new tax, as taking away your savings; there has been a lot of alluding to the savings accounts, picking the pockets of customers; a lot of misinformation has been spread by the American Bankers Association. I don't know how much money they have got invested in this, but if you add up all the money that all the banks and credit unions and S&L's have spent, it would be a multimillion dollar effort, and it's going to cost millions just to answer the mail.

So if we have a problem, we ought to try to work it out. I guess that is my suggestion. But I may be in the minority. We'll find out, I guess, soon.

And I do appreciate your testimony. We will analyze the statements, and thank you very much.

Mr. GARRY. Thank you, Senator.

Senator LONG. Mr. Chairman, I should say that the majority of us on this side of the aisle just do not feel that this hearing would have been held or that we would be here talking about putting more taxes on the banks if the banks had simply rolled over and played dead when that withholding provision was passed.

I think they have every right to take their case to the American people and to come here and tell the Congress both directly and by way of mail that they think that was a mistake.

Now, I note that that measure would not have passed the Senate if 100 Senators had been present and voting. It passed by one vote. There were three absentees, and all three of those were on record as being against the withholding tax.

The CHAIRMAN. I had the Vice President, though.

Senator LONG. Well, the Vice President can only vote if you are tied. You would have been two votes behind.

Furthermore, I don't think that measure could have passed the House. I don't think at any point could it have passed the House if it had been subject to a separate vote in its own right. But it passed because of the conference report where they could only vote on the entire bill—they could not vote on the individual items.

Now, those people have every right under the Constitution to complain to Congress and to seek a redress of their grievance, which they have undertaken to do. The majority of us on this side of the aisle just do not feel that we ought to undertake to do anything that we wouldn't have done otherwise as far as this industry is concerned. We don't think that you ought to in any way be punished because you protested about this measure. You do not agree with the tax measure, and so you appealed to the Congress to rescind something that you think is not a good law.

The majority of us over here are just not convinced. And I have a statement here signed by myself, Senators Bentsen, Matsunaga, Moynihan, Baucus, Boren, Mitchell, and Pryor saying just about that.

[The statement referred to follows:]

STATEMENT OF SENATORS LONG, BENTSEN, MATSUNAGA, MOYNIHAN, BAUCUS, BOREN, MITCHELL, AND PRYOR

Last year the Congress enacted a law requiring financial institutions to withold ten percent of interest earned by most depositors in those institutions. This provision is scheduled to go into effect this July.

Financial institutions have opposed this provision and are making an effort to have it repealed.

It is appropriate for this Committee to examine the tax laws to see that they are fair and are achieving their purposes. If the Treasury Department feels that financial institutions are not paying their fair share of Federal taxes, this Committee should take that change seriously and look into the matter. But we are disturbed that today's hearing is not being held in that context at all. Instead, it appears to be in reprisal for the efforts of financial institutions to repeal the withholding provision.

We believe any citizen in the United States has the right to try to convince the Congress to repeal a law he considers burdensome or unreasonable. We do not believe it is appropriate to threaten him with reprisal if he undertakes to do so.

We will have nothing to do with such a reprisal.

The CHAIRMAN. Well, again, I don't want to get into a quarrel with the former chairman—he may be the chairman again some day—but I just suggest that certainly everybody has the right to petition Congress. But I must also say that this exceeds any petition I have ever heard of. And I know there has been a lot of misinformation.

I know that bankers that you know and bankers like yourself did not put together the copy for the ads, but I do suggest that there is a responsibility on the part of bankers if they find misinformation going to their depositors, that it should be corrected.

Now, you know, this was in the President's 1983 budget; it's not something that somebody dreamed up in this committee—just as it was in President Kennedy's budget, President Carter's budget, President Nixon's budget, President Ford's budget. And a lot of members have been on both sides, and there may be reasons for changing positions.

The point is, there is no direct relationship between this hearing and withholding. But I have said, and I'll repeat, that if we lose the $4 billion a year when this is fully effective, then I assume either we add it to the deficit or we look someplace else for the revenue. I think that's just a fact.

Now, maybe the deficit—we're in this big recovery period where another $4 billion a year doesn't make much difference. But if the ABA thinks this is a fair way to conduct a campaign on withholding, as they must, that certainly is an option they have. It may or may not be related to the fact that they don't pay much tax and they can afford to spend more money on mail, but that's not the purpose of this hearing.

I would again indicate that it is the President's position that withholding is fair; it's going to remain the President's position as far as this Senator is aware. And I don't think he has any conflict with the American bankers across this country. And I would hope that if there is a problem it can be resolved.

I know the popular side of this issue. I don't know why many members would not join Senator Long in saying we ought to get rid of this provision, because if you look at the mail, it's about 10,000 to 1. And if the banks prevail, it will be another indication of their strength. If they don't prevail, it will be an indication of something else, I guess. But it is not your problem, and we'll try to battle it out in Congress. And we wish you the best.

Mr. GARRY. Thank you, Senator.

The CHAIRMAN. Thank you.

We are going to have to come back at 2, because we still have two panels of witnesses. So we will recess until 2.

[Whereupon, at 12:54 p.m., the hearing was recessed.]

AFTERNOON SESSION

The CHAIRMAN. Let me apologize to the witnesses, but we have had about three rollcall votes in this period which takes just about the hour we are late.

Our next witness panel consists of Arthur T. Roth, chairman, National Tax Equity Association; Harold Welsh, first vice chairman, Credit Union National Association; and John J. Hutchinson, president, National Association of Federal Credit Unions.

Your entire statements will be made part of the record as if given in full, and if you could summarize it would be helpful. And you can proceed in any order you wish.

STATEMENT OF JOHN J. HUTCHINSON, PRESIDENT, NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS, WASHINGTON, D.C.

Mr. HUTCHINSON. Mr. Chairman, I am John J. Hutchinson, president of the National Association of Federal Credit Unions, commonly known as NAFCU, and manager of the Hamilton Standard Federal Credit Union in Windsor Locks, Conn. The National Association of Federal Credit Unions is the only national organization exclusively representing the interests of credit unions chartered by the Federal Government. There are approximately 11,631 Federal credit unions throughout the country representing more than 26 million consumer members.

I am pleased to have this opportunity to offer my comments to the committee. I will generally restrict my remarks to provisions of the Internal Revenue Code as they apply to Federal credit unions.

In 1984 we will commemorate the 50th anniversary of the signing of the Federal Credit Union Act. I am pleased to report that after 50 years of service to their members, Federal credit unions continue to faithfully meet their congressional mandate. We have not and will not deviate from the charge given to us by the Congress 50 years ago to cooperatively promote thrift and provide credit for provident or productive purposes.

The credit unions represented by the National Association of Federal Credit Unions have a particular interest in the subject matter under consideration by the committee today, since all Federal credit unions are unique among financial institutions as member-owned cooperatives.

There are many fundamental characteristics that truly differentiate credit unions from other financial intermediaries. They include, but are not limited to, the cooperative form of organization, the common bond, and often a close sponsor relationship.

Credit unions are the only financial institutions that are not merely consumer oriented; they are the consumers. Credit unions are truly cooperative organizations in philosophy, organization, and operation. Each member has one vote regardless of the number of dollars held or the amount of loans owed. Credit unions rely almost completely on volunteerism, and these volunteers are not compensated for their services.

A credit union has no entrepreneurial management or ownership. Credit unions have historically been in the forefront of regulatory changes aimed at benefiting consumers. They are the first financial institutions to completely deregulate the rate paid to savers. In the area of lending, credit unions offer reasonable rates on loans to their members, and have often been cited as providing accurate and detailed information regarding both loan policies and rates.

Each credit union serves a membership limited to a common bond of occupation, association or, in some cases, local residence. Over 80 percent of Federal credit unions have occupational common bonds, and 9 out of every 10 Federal credit union members belong to an occupational credit union.

Credit union membership is not open to the general public, and credit unions may make loans only to their members.

While there are a large number of credit unions, more than 90 percent of all Federal credit unions have less than $10 million in assets. However, even the large credit unions reflect the financial needs of their members, and their philosophy and structure are no different than that of other credit unions. Credit unions are nonprofit organizations. Earnings not paid out in dividends or used to provide services are kept in the credit union for reserves. An accumulation of retained earnings in the credit union in the form of reserves does not indicate a profitmaking purpose.

Because the credit union is not distinguishable from its members, and because all earnings belong to the members, the members are the rightful taxpayers for credit union earnings. No earnings of a credit union go untaxed, because the benefactors of those earnings, the credit union members, all pay the tax.

While credit unions are now eligible and able to provide many of the same kinds of services as many of the other financial institutions, these services are provided only to their members, due to the limitations of their common bond structure. These new powers have not made credit unions "functionally identical" to other financial institutions.

In conclusion, Mr. Chairman, those who might suggest repealing the tax exempt status of credit unions may attempt to invoke the principle of tax equity. In simple terms, they say if the service provided is the same, the tax should be also. That position does not address taxation, but rather competition. Taxation is a redistribution of capital to provide for the payment of all necessary functions of Government. Since the capital of credit unions is always distributed to their members, who then pay their share of taxes, there is, in our judgment, no need to tax credit unions.

Any proposal to repeal or otherwise alter the tax exempt status of credit unions would, I respectfully suggest, demonstrate a lack of understanding of the structure, purpose and operations of credit unions.

That concludes my prepared statement, Mr. Chairman. I would be pleased to answer any question you may have.

[The prepared statement of Mr. John J. Hutchinson follows:]

TESTIMONY OF JOHN J. HUTCHINSON

PRESIDENT OF

THE NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS

INTRODUCTION

Mr. Chairman and members of the Committee on Finance, I am John J. Hutchinson, president of the National Association of Federal Credit Unions (NAFCU), and manager of Hamilton Standard Federal Credit Union in Windsor Locks, Connecticut. The National Association of Federal Credit Unions (NAFCU) is the only national organization exclusively representing the interests of credit unions chartered by the federal government. There are approximately 11,631 Federal credit unions throughout the country representing more than 26 million consumer members.

I am pleased to have this opportunity to offer my comments to the members of the Committee. I will generally restrict my remarks to provisions of the Internal Revenue Code as they apply to Federal credit unions. In 1984 we will commemorate the 50th Anniversary of the signing of the Federal Credit Union Act. I am pleased to report that after 50 years of service to their members, Federal credit unions continue to faithfully meet their Congressional mandate. We have not and will not deviate from the charge given to us by the Congress 50 years ago to cooperatively promote thrift and provide credit for provident or productive purposes.

The credit unions represented by the National Association of Federal Credit Unions have a particular interest in the subject matter under consideration by the Committee today, since all Federal credit unions are unique among financial institutions as member-owned cooperatives.

THE UNIQUE NATURE OF CREDIT UNIONS

The Federal Credit Union Act defines a credit union as a "cooperative association organized in accordance with the provisions of (the Act) for the purpose of promoting thrift among its members and creating a source of credit for provident or productive purposes." (12 U.S.C. 1752(1)) Therefore, according to law, the defined elements of a credit union are: (1) it is a cooperative association, (2) it is organized in accordance with the enabling statute, (3) its purpose is to promote thrift among its members, and (4) to create a source of credit for provident or productive purposes. In carrying out this mandate credit unions provide many services to meet the demands of today's economy.

There are many fundamental characteristics that truly differentiate credit unions from other financial intermediaries. They include but are not limited to the cooperative form of organization, the common bond, and often a close sponsor relationship.

At the beginning of the 1970s, credit unions had no independent regulatory agency, no share insurance, and few powers enjoyed by other financial institutions. Given the foregoing, they had little capacity to cope with a decade of radical changes and increasing financial needs of their members. Credit unions therefore increased their political presence at both the state and national level.

By the end of the 1970s, much of that had changed. Credit unions matured and were strenghtened by creation of a federal share insurance system and expanded powers provided by Congress. As a result of these factors, credit unions were increasingly accepted by their members and were aided by the rapid expansion of the economy and the financial institution marketplace in general. The credit union industry responded to the call for wider consumer services through technical innovation and by working cooperatively with lawmakers and regulators to bring about improvements in the legislative and regulatory environment without changing the fundamental philosophy of credit unions.

The fundamental concerns of the credit union community continue to include: the need to stablize the economy and reduce inflation; the need to reduce in an orderly fashion, unnecessary government presence in the marketplace; the need to continue the long tradition of credit union consumer financial services to members; the need to re-emphasize the unique nature of credit unions; and to focus on the cooperative principles at the core of the credit union concept. Credit unions are the only financial institutions that are not merely consumer oriented, we are the consumer.

CREDIT UNION ORGANIZATION IS DIFFERENT

Credit unions, unlike most other financial institutions, are truly cooperative organizations in philosophy, organization and operation. A credit union is formed by a group of persons usually because the existing structure of financial services has failed to provide for their needs. The fundamental purposes of a credit union still remain to encourage thrift, to provide a source of low-cost consumer credit, and to promote prudent financial management among its members just as it always has.

In a credit union, the members manage the operations through the democratic process. Each member has one vote, regardless of the number of dollars held or the amount of loans owed. Because the philosophy of the credit union is one of self-help, the operations of most credit unions rely almost completely on volunteerism and all Federal credit union have a volunteer board of directors. A credit union may not compensate its board members, nor may it compensate its supervisory and credit committee members. Thus, a credit union has no entrepreneurial management or ownership. The credit union is the sum of its members who cooperatively provide sound financial management of their own funds. A credit union's operating policies are determined democratically by its members who are its borrowers, its savers, its owners and its benefactors.

CREDIT UNIONS AS CONSUMER COOPERATIVES

Credit unions have historically been in the forefront of regulatory changes aimed at benefiting consumers. For example, the National Association of Federal Credit Unions, in countless appearances before various Congressional Committees in the 96th and 97th Congresses, repeatedly advocated the total deregulation of credit union share accounts, which are the functional equivalent of passbook accounts offered by other financial institutions. I am pleased to report that by cooperatively working with our agency, NAFCU's efforts ultimately met with success when on April 22, 1982 the National Credit Union Administration Board promulgated a final rule totally deregulating the rate that credit unions may pay on credit union shares.

The members of this Association are proud of the leadership role credit unions have taken in guaranteeing that savers realize the highest possible rate of return available in a highly competitive financial marketplace. In the past we have resisted and will continue to resist the imposition of artificial caps on the rates that may be paid to savers. Similarly, we have opposed and will continue to oppose any Federal intervention that would needlessly reduce the yield a credit union member receives on his or her savings. After all, in many cases credit union savings are the only source of thrift many of these people have.

Credit unions have an outstanding record when it comes to rewarding savers, and we take a back-seat to no one when it comes to offering reasonable rates on loans to our members. Credit unions have been often cited as providing the most accurate and detailed information regarding both loan policies and rates. In fact, many send their members quarterly newsletters providing detailed information on the policies of the credit union and why they were established.

THE CREDIT UNION COMMON BOND

Each credit union serves a membership limited to a common bond of occupation, association or, in some cases, local residence. Other financial institutions are open to the general public for both deposit and lending activities, and may make loans to non-depositors. However, credit union membership is not open to the general public, and credit unions may make loans only to their members. This limitation is imposed by Section 109 of the Federal Credit Union Act (12 U.S.C. 1759).

I do not know how many members of the Committee are members of the United States Senate Employees Federal Credit Union. However, I do know that you are all eligible to belong to that credit union because you fall within the "common bond" of people who the credit union is chartered to serve. Yet, there are many people who live on Capitol Hill, and others who visit the Capitol buildings daily, who are not eligible to belong to U.S. Senate Employees Federal Credit Union because they are not members of the Senate or its employees. As you can see, the common bond limitation effectively inhibits the growth of credit unions and prevents credit unions from competing directly with other financial institutions.

While some may assert that the opportunity to apply for a credit union charter under the statutory provisions which permit a residential common bond has made credit union membership open to the general public, the facts demonstrate that this is clearly not the case. Residential or community Federal credit unions comprised only 4.7 percent of all Federal credit unions in 1981 and had only 5.1 percent of Federal credit union members. More than half of these serve rural communities where limited financial services are available.

In 1982, only 8 new federal charters were granted for community credit unions—down from 14 in 1981. On the other hand, almost 80.2 percent of Federal credit union charters in 1981 were for much more narrowly defined occupational common bonds. Occupational common bonds are generally the most restrictive form of common bond. Over 80 percent of Federal credit unions have occupational common bonds, and 9 out of every 10 Federal credit union members belong to an occupational credit union. Even occupational bonds are often restricted to employees at a certain location rather than to all employees of a national firm. For example, rather than a single large credit union serving all members of Congress and their staffs, there are two smaller credit unions serving more narrowly defined fields of membership: Senators and their staffs may belong to U.S. Senate Employees Federal Credit Union, while House members and their staffs may join Wright Patman Congressional Federal Credit Union.

As you can see, the legal concept of a limited common bond continues to remain well-defined.

CREDIT UNION SIZE

Although the growth of credit unions has been substantial over the past decade, the overwhelming majority of credit unions remain quite small. The small size of most credit unions results from the limitations that necessarily flow from the common bond.

As of December 31, 1981 there were 11,969 Federal credit unions. Of this number....

9,020 or 75.4% had assets of less than $2 Million
10,496 or 87.7% had assets of less than $5 Million
11,190 or 93.5% had assets of less than $10 Million
11,583 or 96.8% had assets of less than $20 Million
11,851 or 99.0% had assets of less than $50 Million

Thus, large credit unions, although commonly cited by critics as examples of "typical" credit unions, are clearly exceptions. They represent large numbers of members, but they do not represent the majority of the credit unions. I hasten to add, however, that larger credit unions do reflect the financial needs of their members, and their philosophy and structure are no different from that of other credit unions. They have traditionally served the needs of all who sought their services and have not limited the credit union's services to special interest groups.

While there are many credit unions, they hold only 4.6% of all consumer deposits in regulated depository institutions. The facts reveal that the vast majority of credit unions are so small that many credit unions operate with fewer assets than the minimum necessary to charter a bank or a savings and loan association. In almost every case, these small credit unions provide financial services not available elsewhere to consumers.

CREDIT UNION OPERATIONS

Credit unions are nonprofit organizations. Although a credit union often realizes net earnings over the cost of its operations, these earnings are not the purpose for which a credit union is formed. They are the results of the cooperative effort of many non-paid volunteers. Members receive the benefits of any earnings in the form of lower loan interest rates, increased dividends, as well as interest refunds, and the creation of additional services.

Earnings not paid out in dividends or used to provide services are kept in the credit union for reserves as required by law and other reserves to maintain the financial stability of the credit union. These retained earnings may be used to meet unexpected or cyclical financial needs of the members.

For example, many credit unions are occupational in nature and serve employees of manufacturing companies. The entire membership of such a credit union could face the possibility of layoffs or other acute financial difficulties during periods of economic instability. It is under these circumstances that a credit union is relied upon to provide the credit and financial services for which it was created.

Events such as plant closings cause increased loan demand, delayed repayments, decreased savings and higher rates of withdrawals. At such times retained earnings held in the credit union become vital to the financial well-being of its membership.

Incidentally, plant closings are not the only occurrences related to an employer's activities which can have a devastating impact upon credit unions and their members. The Congressional budget and appropriations process has a significant impact upon the safety and soundness of certain government credit unions, to say nothing of the livelihood of these credit union members. Barring emergency Congressional action, when the Senate and House fail to approve appropriations bills prior to the beginning of each fiscal year, the issuance of government paychecks and their direct deposit in financial institutions is interrupted.

At times like this, many of these credit unions establish special loan plans, often at no interest or at reduced interest rates to help their members through this difficult period. Of the 11,969 Federal credit unions chartered in the United States as of December 31, 1981, 810 served fields of membership comprised of "Federal Government" employees and 225 Federal credit unions served members of the military forces. These credit unions hold over $10.5 billion in assets.

Other financial institutions can minimize the risk of financial damage that may stem from plant closings, lapsed Federal appropriations, or other causes by soliciting a diverse group of borrowers and depositors, thus reducing the risk inherent in the occurrence of a financial disaster in any one group or another. Credit unions are prevented by their common bond structure from spreading the risk in this fashion.

For these reasons the credit union may want to plan for the unexpected by retention of earnings in reserves. But, over the long run all retained earnings will be returned to the members. Because of its lack of an entrepreneurial element, there is nowhere else for earnings of a credit union to go. The credit union is its members and, as such, will not realize any profits.

Credit unions usually grow in response to actual or anticipated needs of their members. Retained earnings not paid out in dividends will help to ensure that the credit union has sufficient funds to survive hard times resulting from such events as plant closings or relocations or cyclical economic depressions.

An accumulation of retained earnings in the credit union in the form of reserves does not indicate a profit-making purpose over the long term. Without some retained earnings, credit unions may not continue to meet the needs of their members.

Because the credit union is not distinguishable from its members, and because all earnings belong to the members, the members are the rightful taxpayers for credit union earnings. Therefore, credit unions report to I.R.S. all earnings paid out to the members. The members pay taxes on their dividends from the credit union, and retained earnings when paid out to members will be subject to taxation as well. No earnings of a credit union go untaxed because the benefactors of the earnings, the credit union's members, all pay the tax.

SELF-SUPPORTIVE NATURE OF CREDIT UNIONS

The bulk of work done at credit unions is carried out by volunteers. This operational distinction is one of the many factors that makes credit unions different from other financial institutions. Volunteerism is a basic element of the credit union philosophy.

The truly mutual nature of credit unions means they are self-supporting; the membership is the primary source of both operating funds and income. Credit unions do not have access to large corporate, commercial and government deposits like other financial institutions. Earnings from member loans are used to pay dividends. Excess savings have usually been invested back in government issues that yield low return that will usually help housing or other taxpayer needs.

Particularly significant are some findings presented to the House Committee on Banking, Finance and Urban Affairs by the Chairman of the National Credit Union Administration Board, Edgar F. Callahan, on February 23 when that panel examined the current problem of mortgage foreclosures. In his testimony Chairman Callahan:

> produced one story after another of how credit union managers and boards of directors are making every effort and using all of the resources of the credit union to ensure that no credit union member unnecessarily suffers the loss of a home. In all, 75 credit unions were contacted and in every case the

> attitude of the credit union was to try and find a way to enable the member to keep the house. The types of assistance ranged from debt restructuring, to financial counseling, to extended payments, to reduced payments, and even to the carrying of the payment by the credit union pending a change in the personal circumstances of the member.

The self-help member owner concept of credit unions makes this possible.

CREDIT UNIONS REMAIN DIFFERENT FROM OTHER FINANCIAL INSTITUTIONS DESPITE RECENT EXPANDED POWERS

In recent years credit unions have been authorized by Congress to offer their members a number of additional services. I would like to address this point, because some have said that these new powers have made credit unions "functionally identical" to other financial institutions.

Even though credit unions are now able to provide many of the same kinds of services as other institutions, such as residential mortgages, lines of credit, and credit cards, they were authorized to do so only because their members had needs that other financial organizations were not fulfilling. However, because of the credit union's limited field of membership, credit unions do not generally compete in the open marketplace for potential customers. Moreover, the small size of most credit unions has prevented the majority of them from implementing their full range of powers, since more than 87% of all credit unions have assets of less than $5 million. Expanded powers should make it possible for these smaller credit unions to bring to a large percent of consumers greater opportunities to save.

It is important to recognize that each of the various types of financial institutions performs a specific function in order to meet particular credit needs within the financial marketplace. Although some activities do overlap, the primary functions of each institution remain different. The purpose of credit unions is to promote thrift and provide credit to individuals within a very well-defined field of membership. The recently expanded powers of credit unions relate almost exclusively to the types of services which may enhance the capacity of credit unions to meet those needs, and thereby comply with their statutory mandate.

As our country grows and expands into new methods of financial management credit unions also must be able to meet those changes and keep providing the services in the manner that has made them unique.

In addition to Federal credit unions, there are hundreds of similar organizations operating as instrumentalities of the Government which are exempt from tax under Section 501(c)(1) of the Internal Revenue Code. Equity should require that Federal credit unions not be singled out from these other 501(c)(1) organizations to find their tax status challenged.

CONCLUSION

Those who might suggest repealing the tax exempt status of credit unions may attempt to invoke the principle of tax equity. In simple terms they say, if the service provided is the same, the tax should be also. That position does not address taxation, but rather competition. Taxation is a redistribution of capital to provide for the payment of all necessary functions of government. Since the capital of credit unions is always distributed to their members, who then pay their share of taxes, there is no need to tax credit unions.

Any proposal to repeal or otherwise alter the tax-exempt status of credit unions would, I respectfully suggest, demonstrate a lack of understanding of the structure, purpose and operations of credit unions.

Mr. Chairman, that concludes my prepared statement. I would like to thank you for the opportunity to appear before your Committee this morning, and I would be happy to respond to any questions you or the other Committee members might have. Thank you.

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EXECUTIVE SUMMARY

Testimony of John J. Hutchinson Before the
Committee on Finance of the U.S. Senate
March 11, 1983

Unique Nature of Credit Unions: There are many fundamental characteristics that truly differentiate credit unions from other financial intermediaries. They include but are not limited to the cooperative form of organization, the common bond and often a close sponsor relationship. Credit unions are the only financial institutions that are not merely consumer-oriented; they are the consumers.

Credit Union Organization Is Different: Credit unions are truly cooperative organizations in philosophy, organization and operation. Each member has one vote regardless of the number of dollars held or the amount of loans owed. Credit unions rely almost completely on volunteerism and these volunteers are not compensated for their services. A credit union has no entrepreneurial management or ownership.

Credit Unions As Consumer Cooperatives: Credit unions have historically been in the forefront of regulatory changes aimed at benefiting consumers. They are the first financial institutions to completely deregulate the rates paid to savers.

The Credit Union Common Bond: Each credit union serves a membership limited to a common bond of occupation, association or, in some cases, local residence. Over eighty percent of Federal credit unions have occupational common bonds, and nine out of every ten Federal credit union members belong to an occupational credit union. Credit union membership is not open to the general public and credit unions may make loans only to their members.

Credit Union Size: While there are a large number of credit unions, more than ninety percent of all Federal credit unions have less than $10 million in assets. However, even the large credit unions reflect the financial needs of their members, and their philosophy and structure are no different than that of other credit unions.

Credit Union Operations: Credit unions are non-profit organizations. Earnings not paid out in dividends or used to provide services are kept in the credit union for reserves. An accumulation of retained earnings in a credit union in the form of reserves does not indicate a profit-making purpose. Because the credit union is not distinguishable from its members and because all earnings belong to the members, the members are the rightful taxpayers for credit union earnings. No earnings of a credit union go untaxed because the benefactors of the earnings, the credit union members, all pay the tax.

Conclusion: Credit unions are truly cooperatives in structure, purpose and operation. Since the capital of credit unions is always distributed to their members, who then pay their share of taxes, there is no need to tax credit unions.

The CHAIRMAN. All right. Let's hear from Mr. Welsh.

STATEMENT OF HAROLD T. WELSH, PRESIDENT, GENERAL FOODS EMPLOYEES CREDIT UNION, KANKAKEE, ILL.

Mr. WELSH. Thank you, Mr. Chairman. To clear up the confusion on my name, it is Harold T. and I go by Tom Welsh. I am the president of the General Foods Employees Credit Union in Kankakee, Ill., and the first vice chairman of the Credit Union National Association [CUNA]. CUNA represents 90 percent of the Nation's 20,000 State and Federal credit unions. Today, credit unions provide more than 47 million Americans with a broad array of financial services. Nonetheless, they remain unique among financial institutions. The best way to describe credit unions' special character is to paraphrase what a CUNA representative told Congress in 1951 when lawmakers then, as now, considered changes in the tax status of financial institutions.

Our representative in 1951 reminded Congress that a credit union does not do business with the general public and does not in the usual sense earn a profit. It is a cooperative association organized for two basic purposes: promoting thrift among its members and supplying them with needed loans for useful purposes at reasonable cost. Out of the income derived from loans, the credit union pays its operating expenses, setting aside a portion of earnings each year as a reserve against possible bad loans. Any remaining income is used to pay member dividends on their savings account; to provide rebates of interest on loans, and to improve services.

Each credit union is self-managed by directors and committees selected by and from the members. None may be compensated for their services. They contribute time and effort for the welfare of their members. A credit union is a self-help organization, one which Government, industry, churches, labor, and others recognize for its value and benefit to people of small means. Those are the comments of CUNA to Congress 30 years ago. Today, credit unions continue to operate in the same basic manner.

I can give you a few examples that might help make the understanding clear on how the principles are put in practice today.

We had a letter from the manager of the United States Steel Products Credit Union in Port Arthur, Tex., recently, and she said that on Saturdays, Sundays, and holidays she can and has been reached at home by her members with financial emergency. She also notes her board of directors—all voluntary—spend an average of 5 hours per week of their free time studying regulations, counseling members on their financial situation. Finally, she explains that a credit union member with building skills has donated time and material to repair or enhance the credit union office.

Typically, if a borrower becomes ill or gets laid off from his job, the credit union will bend over backwards to give that member a break. For instance, 700 members of the AAC Employees Federal Credit Union of Columbia Falls, Mont., were recently laid off by the company. A local banker said that they could only reduce the workers' loan payments in half for 6 months before repossession or foreclosure. In contrast, the credit union decided it would extend loan payments 60 months without raising the original interest rate. For some members, this change meant that their loan payments dropped by more than half. The credit union continued to provide its laid off members with disability and life savings insurance. The credit union is also maintaining a barter board to help these people find odd jobs and help sell personal property to tide them over.

Credit unions also help other credit unions serve their members. The manager of the Lawton Teachers Federal Credit Union of Lawton, Okla., had a call in 1981 from an employee of the local Goodyear plant. He wanted to know how to organize a credit union. The Lawton Credit Union manager met with Goodyear at nights and on Sundays to help them start their credit union, and once started, to figure their first dividend and set up loan policies.

Seventy-five percent of all credit unions in this country have less than $2 million in assets. Many of them operate with volunteer or paid part-time staff. Their small size forces them to look to one another for help. In Springfield, Ohio, for example, four small credit unions share the same building, equipment and staff. Each credit union handles its own publicity, provides its own stationery, but all of them share counter space and display board in the common lobby. Tellers are trained to serve members of all four credit unions. By sharing, the credit unions are able to provide full, 5-day week service, which, individually, the small credit unions could not have done.

I, myself, spend free time, and have the last 2 weeks, attempting to salvage a $35,000 credit union. They need help in their loan policies and how to market that credit union for their membership. I have their loan portfolio; brought it with me on the plane, to attempt to solve that for them.

The committee should understand that the actions of these credit unions are not unique. I could site many other examples that illustrate how credit unions differ from other financial institutions, but my time is up.

Let me conclude by repeating what CUNA told Congress in 1951, namely, that we realize sufficient funds must be raised through taxation to reduce the Federal deficit and to support the Government. But we feel very strongly that the present tax position of the credit union should be maintained, and, therefore, we wish to register our opposition to any proposal which would make changes in this position. Thank you very much.

[The prepared statement of Harold T. Welsh follows:]

STATEMENT OF THE CREDIT UNION NATIONAL ASSOCIATION, INC.

Good day. My name is Harold T. Welsh. I am the President of the General Foods Employees Credit Union, Kankakee, Illionois, and the First Vice Chairman of the Credit Union National Association, Inc. The Credit Union National Association, Inc. (CUNA) represents more than 20,000 of the nation's state and federally chartered credit unions through 52 member credit union leagues. These leagues are located in each of the states, the District of Columbia and Puerto Rico. America's credit unions serve more than 47 million members.

UNIQUENESS OF CREDIT UNIONS

Credit unions are non-profit, member-owned cooperative financial institutions. Membership is limited to persons within a field of membership--general employment, association or geographic in nature. Credit unions are democratically controlled with each individual member of the credit union having one vote, regardless of the number of dollars on deposit at the credit union. As democratically controlled financial cooperatives, the consumer orientation of these institutions is insured. These unique financial institutions return to their owner-members every penny of income earned in excess of operating expenses, required reserves and undivided earnings transfers. More than 47 million consumers have joined credit unions because they offer loans at reasonable rates and offer a high rate of return on member savings.

STATUTORY FRAMEWORK

The Federal Credit Union Act and most state credit union laws establish a statutory framework that insures the unique character of credit unions. The key features common to credit union statutes include:

- A common bond among members.
- Volunteer leadership.
- Democratic control with each member having one vote regardless of the number of shares in the credit union purchased.

- Non-profit status and no capital stock.
- Statutory reserves.
- Exemption from federal income taxation.

During the past half century, the fundamental purpose, goals and objectives of credit unions have remained unchanged. Credit unions were authorized as the alternative to commercial banks for the average saver of limited means. The first credit union established was the La Caisse Populaire of Ste. Marie in New Hampshire in 1909. (The translation of La Caisse Populaire is The Peoples Bank of St. Mary's Parish -- an associational common bond). Credit unions grew at the state level and by 1933, more than 5,000 had been chartered. The Federal Credit Union Act (12 U.S.C. § 1751 *et seq.*), passed in 1934, declared as its purpose "to make more available to people of small means credit for provident purposes through a national system of cooperative credit, thereby helping to stabilize the credit structure of the United States."

ORIGIN OF SPECIALIZED TAX TREATMENT

The predecessor of federal income tax, as we know it today, was enacted in 1913, immediately after the Sixteenth Amendment to the Constitution became effective. At that time there were some 70 credit unions in existence, all state-chartered.

Credit unions were not exempted by the original 1913 income tax act. That law did, however exempt from taxation mutual savings banks, domestic building and loan associations, as well as a number of labor, agricultural, fraternal, charitable, religious, educational, and scientific organizations. [1/] In 1916, the Act was amended to exempt cooperative

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[1/] 38 Stat. (emphasis added) states: "Provided, however that nothing in this section shall apply to labor, agricultural, or horticultural organizations or to *mutual savings banks not having a capital stock represented by shares*, or to fraternal beneficiary societies, orders or associations operating under the lodge system for the exclusive benefit of members of a fraternity itself operating under the lodge system..., nor to *domestic building and loan associations* ,...., nor to any corporation or association organized and operated exclusively for religious, charitable, scientific, or educational purposes, no part of the net income of which inners to the benefit of any private stockholder or individual, nor to business leagues, nor chambers of commerce, nor boards of trade, not organized for profit...."

banks.[2]

Congress gave the original exemption from federal income taxes to domestic building and loan associations, mutual savings banks and cooperative banks for a definite reason. As then constituted, these organizations shared the characteristics of being mutually organized, non-profit institutions, whose purpose was to serve their members. Although credit unions shared those characteristics, they went unnoticed at first because of their miniscule size. As soon as it was pointed out that credit unions were the classic form of non-profit, cooperative financial institutions, the exemption was extended to them.

In order to fully appreciate the tax policy underlying the specialized treatment of credit unions, it must be remembered that prior to 1894, congressional legislation taxing an entity specified the entity to be taxed. In other words, if an entity was not specifically mentioned in a tax law, it was not taxable. In 1894, when Congress imposed a 2% tax on corporate income, Congress had to focus on the exact entities it wished to subject to taxation. Thus, Congress began the process of wrestling with tax policy. Though the 1894 tax was ultimately declared unconstitutional, congessional debate on the exemptions show clear recognition of the unique place held by truly non-profit consumer cooperative financial institutions. The following 1894 Senate debate, although not dealing with credit unions, illustrates the point:

> Argument ought not to be necessary to sustain the proposition that mutual savings banks should be absolutely exempt from any income taxation.
>
> They represent the savings of the poor; they are not established for ordinary business purposes; the earnings -- aside from those necessary for legitimate expenses, belong to the depositors, and are paid to them from time to time in the shape of interest or dividends; they ordinarily have no capital stock, and the managers are simply the agents who are simply the agents or trustees of the depositors.
>
> ...This Government cannot afford to permit the savings of the poor to be taxed through the Federal income tax. It would be the crowning infamy of this bill. (26 Cong. Rec. 6622 June 21, 1894).

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[2] 39 Stat. 766 provides that: "...[T]here shall not be taxed under this title any income received to by any ... Domestic building and loan association and cooperative banks without capital stock organized and operated for mutual purpose and without profit...."

The exemption for mutual savings banks was included in that legislation, and continued in the Revenue Act of 1913 which followed the ratification of the Sixteenth Amendment. The exemption from income taxation which was granted to federal credit unions in the 1934 Federal Credit Union Act was without doubt premised on the same concerns.

In 1917, the Secretary of the Treasury requested that the United States Attorney General render an opinion regarding the income tax liability of credit unions organized under the Massachusetts Credit Union Act of 1915. In a November 1917 ruling, the Attorney General declared his opinion that Massachusetts credit unions (and by inference credit unions in other states as well) were exempt from federal income tax because of their similarity to cooperative banks and building and loan associations (as they were organized and operated at that time). The opinion declared in part:

> "The similarity between credit unions and cooperative banks, as they exist in Massachusetts, is striking. Having in mind the history of the insertion of the fourth paragraph, section 11 of the income tax law, it must be conceded that although credit unions do not come within the letter of the paragraph, such associations are wholly within the intention and meaning of Congress as therein expressed. Because the words 'credit union' were not specifically used is certainly no reason for saying that such organizations are subject to the tax imposed by the act, if on examination of the purpose and the object of such associations it appears that they are substantially identical with domestic building and loan associations or cooperatives 'organized and operated for mutual purposes and without profit.'"

This opinion was to become the basis for the exemption for state chartered credit unions which was enacted in 1951 (26 U.S.C. § 501(c)(14)).

The bill which was later to become the Federal Credit Union Act first proposed an exemption of federal credit unions from all federal taxation except taxation on real property. Although this language was included in the Senate-passed version, the House of Representatives eliminated the exemption and further permitted the states to tax federal credit unions. Thus, the original Federal Credit Union Act as adopted in 1934 contained no specific exemption from federal taxation for federal credit unions.

In response to an inquiry from the General Counsel of the Farm Credit Administration,[3] the Commissioner of the Internal Revenue ruled in June 1935 that, upon proper certification from the supervisory agency, federal credit unions would be granted exemption from federal income tax. In 1937, Congress adopted amendments to the Federal Credit Union Act, primarily to provide federal credit unions with relief from state taxation, but specific exemption from federal taxation was also included.[4]

Federal credit unions also derive tax exemption directly from the Internal Revenue Code (26 U.S.C. § 501(c)(1); see also, Rev. Rul. 55-133, 1955-1 C.B. 138). Section 501(c)(1) exempts corporations organized under an act of Congress, if such corporations are instrumentalities of the United States and, if, under the enabling act as amended or supplemented, those corporations are exempt from federal income tax. The original FCU Act specified that federal credit unions would act as fiscal agents of the United States upon request of the Secretary of the Treasury (12 U.S.C. § 1767). That provision, under which federal credit unions were and are still deemed federal instrumentalities, provides another basis for the exemption from federal income taxation. Both the Internal Revenue Service and the courts have affirmed that federal credit unions are federal instrumentalities.[5]

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[3] Federal credit unions were, under the original Federal Credit Union Act, placed under the supervision of the Farm Credit Administration. This was done for several reasons, among which were the fact that: (1) a number of credit unions then contemplated would be serving rural communities, and (2) credit unions resembled both in function and characteristics certain elements of the farm credit system.

[4] "Sec. 18. That the federal credit unions organized hereunder, their property, their franchises, capital, reserves, surpluses, and other funds, and their income will be exempt from all taxation now or hereafter imposed by the United States or by any state, territorial, or local taxing authority; except that any real property and any tangible personal property of such federal credit union shall be subject to federal, state, territorial, and local taxation to the same extent as other similar property is taxed" (12 U.S.C. § 1768).

[5] The IRS published its recognition in Internal Revenue Memograph 6687, September 19, 1951. Some of the court decisions which affirm that federal credit unions are instrumentalities of the U.S. include: Wekearnyan Federal Credit Union v. Zuna, 31 A. 2d 490 (1943); Tabco

The various debates surrounding the enactment of the tax exemption for credit unions illustrate the rationale for the special status and provide the points of analysis for its continuing validity. Section 16 of S. 1639, introduced by Senator Shepherd, 73rd Congress, 1st Session, May 11, 1933, establishing a federal credit union system provided that "Federal credit unions, but not the members thereof, shall be exempt from all federal taxation except taxes upon real property." The Senate deliberations on S. 1639 resulted in the deletion of the provision exempting all credit unions from taxation on March 29, 1934. The provision was dropped to clear passage of the Federal Credit Union Act with the acquiesence of the credit union movement. As finally adopted, section 18, according to the report accompanying S. 1639, "permits the taxation of the shares of stock of a federal credit union as personal property of the owner; and permits federal credit unions to be taxed under state authority in the same manner and not exceeding the rate imposed upon domestic banking corporations."

By 1936 it became obvious to the 74th Congress that taxation of credit unions had been a mistake. S. 4104 was introduced on February 24, 1936, to eliminate provisions permitting tax on credit union shares. Although no action resulted in the 74th Congress, Senator Shepherd introduced a similar bill early in the 75th Congress (S. 649). However, it was not until June 15, 1937, when Senator Shepherd introduced S. 2675, covering examination fees, investigation, research, and studies, exemption from taxation, and space in federal buildings that the needed legislation was fully considered.

(cont'd). Federal Credit Union v. Goldstein, (Balt. Co., Md. Cir. Ct.) 6/22/64, cited in Central Credit Union v. Comptroller of Treasury, 220 A. 2d 568 (Md. Ct. App., 1966); Electrical Federal Credit Union v. State Department of Revenue, Civil Action No. C-13176, 12/7/70 (D.C. Denver, Co.); Mosco v. United States, 310 F. 2d 180, (9th Cir. 1962).

State-chartered credit unions are subject to taxation on unrelated business income. This provision was inserted in the IRS Code by the Tax Reform Act of 1969. Federal credit unions, however, are still exempt from this tax by virtue of their being deemed instrumentalities of the United States. Section 121(a)(1)(A) of the Tax Reform Act of 1969 reads in pertinent part: "... [T]he taxes imposed by (this Act) shall apply in the case of any organization other than ... an organization described in section 501(c)(1) which is exempt...."

In hearings before the Subcommittee of the Banking and Currency Committee of the United States Senate (May 11, 1937 on S. 649), W. I. Myers, Governor of the Farm Credit Administration, commented:

> [The bill amends] section 18 of the Federal Credit Union Act to provide the method of taxing federal credit unions. This proposed section exempts federal credit unions from all tax except that upon real property and tangible personal property....
>
> The present Federal Credit Union Act permits the taxation of any federal credit union by the state in which it is located, or its property, by authority of such state in the manner and not to exceed the rate imposed upon domestic banking corporations. Many states tax domestic banking corporations in relation to their share of capital.
>
> In view of the fact that federal credit unions may not accept deposits, their capital represents a much greater proportion of their total resources than is the case in other financial institutions. Experience with federal credit unions since the passage of the original Act indicates that such taxation, therefore, places a disproportionate and excessive burden on them. Furthermore, these credit unions are mutual or cooperative organizations operated entirely by and for their members and in view of this fact it is appropriate, we feel, that local taxation should be levied on the members rather than on the organization itself. It is our opinion that this amendment is desirable and it is recommended for favorable consideration.

The rationale stated by Governor Myers was carried forward in the Senate report accompanying S. 2675 (July 30, 1937, Report No. 1009, 75th Congress, 1st Session, United States Senate).

Representative Luce of Massachusetts, speaking before the House (November 24, 1937), stated that the credit union "system has no element of profitmaking whatever." Mr. Luce noted that the exemption of federal credit unions from taxation, except taxation on real and tangible personal property, "also prohibits the placing of the burden of collecting the tax upon the credit unions themselves." Like his Senate counterparts, Representative Luce was favorably disposed toward the legislation because federal credit unions are "mutual or cooperative organizations operated entirely by and for their members." Mr. Church, a Republican from Illinois, was even more direct stating that those "interested in these credit unions are wage earners all over

America. They would appreciate their Thanksgiving tomorrow all the more if you would take these obstructive tax burdens off the businesses of their country."

The Federal Credit Union Act was amended to specifically exempt federal credit unions from federal income laws in December 1937.

In 1951 the Congress made a number of changes in the tax-exempt status of financial institutions. H.R. 240, the Tax Equalization Act of 1951, and H.R. 1177 were bills "designed to equalize taxation by imposing income taxes on cooperative corporations and on the business income of certain other tax-exempt corporations and organizations including building and loan associations, federal savings and loan associations, mutual savings banks, cooperative banks, credit unions, farm loan associations, production credit associations and electric and telephone cooperatives."

Hubert Rhodes, testifying before the Senate Committee on Finance on July 18, 1951, on behalf of the Credit Union National Association and its 8,000 member credit unions, stated:

> "[A credit union is] cooperative association organized within well-defined groups of people for the two-fold purpose of promoting thrift among its members and supplying them with needed loans for useful purposes at reasonable costs.... The credit union is a service organization to promote systematic savings even when such may be in very modest amounts, and to help eliminate usurious charges for short-term personal loans. Out of the income derived for its low-cost loan service, the credit union pays expenses of operation and sets aside a portion of earnings each year as a reserve against possible bad loans. The remainder is available for members to pay themselves interest on their savings accounts. Each credit union is self-managed by directors and the committees selected by and from members. None of these may be compensated for their services. They contribute time and effort for the welfare of their members.... The credit union is not formed to make profits, it does not do business with the general public, and any financial return from its operation on a mutual basis is distributed to members. It is a self-help organization and one which government, industry, churches, labor and others recognize for its value and benefit to people of small means.
>
> "We feel very strongly that the present tax position of the credit union should be maintained and, therefore, we wish to register opposition to any proposal which would make changes in this position."

Credit unions' tax-exempt status remained intact even though the Revenue Act of 1951 eventually removed the tax-exempt status of mutual savings banks and savings and loans. The legislative history of the Revenue Act of 1951, for instance, states:

> Mutual savings banks were established to encourage thrift and to provide safe and convenient facilities for savings. They also have the responsibility of investing the funds left with them so as to be able to give their depositors a return on their savings. Mutual savings banks were originally organized for the principle purpose of serving factory workers and other wage earners of moderate means who, at the time these banks were started, had no other place where they could deposit their savings.
>
> At the present time, mutual savings banks are in active competition with commercial banks and life insurance companies for the public savings, and they compete with many types of taxable institutions in the security and real estate markets. As a result, your Committee believes that the continuance of the tax-free treatment now accorded mutual savings banks would be discriminatory. So long as they are exempt from income tax, mutual savings banks enjoy the advantage of being able to finance their growth out of earnings without incurring the tax liabilities paid by ordinary corporations when they undertake to expand to use of their own reserves. The tax treatment provided by your Committee place mutual savings banks on a parity with their competitors." (Senate Report No. 781, 1951-2, C.B. 476 (emphasis added))

The reasons for removing the tax-exempt status of mutual savings banks also applied to savings and loan associations:

> "The grounds on which your Committee's bill taxes savings and loan associations on their retained earnings, after making a reasonable allowance for additions to a reserve for bad debts, are the same as those on which mutual savings banks are taxed under the bill. Moreover, savings and loan associations are no longer self-contained cooperative institutions as they were originally organized. There is relatively little difference between their operations and those of other financial institutions which accept deposits and make real estate loans." (Senate Report No. 781, 1951-2 C.B. 478.)

Thus, the reasons for removal of the tax-exempt status for mutual savings and banks and savings and loans associations was their fundamental departure from the principles and purposes of their formation. The difference between these organizations and other financial institutions subject to federal income tax was, in the view of Congress, minimal. It follows that the reason for the retention of the tax-exempt status of credit unions in 1951 was the absence of any indication that credit unions had deviated from their original purpose and characteristics. CUNA strongly believes that the characteristics which separated a credit union from a bank or savings and loan association in 1951 remain unchanged. Although a credit union in 1983 may offer a much wider array of financial services to its members than it did in 1951, the way these services are performed continues to distinguish credit unions from other financial institutions to such a degree that their tax-exempt status should be preserved.

CHARACTERISTICS OF CREDIT UNIONS

COMMON BOND

The Federal Credit Union Act requires each credit union to have a common bond of occupation, association, or residence within a well-defined geographic area. Credit unions are not open to the general public. The majority (80%) are still based on a common bond of occupation. That is, these credit unions serve the employees of one or more businesses. Another group of credit unions (16%) serve individuals associated with a particular group or organization, such as a church parish. A small number of credit unions (4%) serve individuals living within a well-defined geographic area. Community credit unions hold only 4% of the savings in credit unions and are frequently organized to serve residents of low-income areas, for instance, West Philadelphia Community Federal Credit Union of Philadelphia, Pennsylvania with median income in its geographic area of $11,000.

The continuing vitality of the common bond requirement is demonstrated through a number of operational constraints that are quite different from those in other financial institutions. First, credit unions continue to rely on member savings to generate funds for loans. The external generation of capital is very limited in the credit union movement. Therefore, when a member borrows from the credit union, there is a greater sense of loyalty and commitment to repaying the loan because the funds are in fact borrowed from coworkers and fellow members.

Second, despite growth and new powers granted over the past decade, credit unions remain small institutions. More than half of them, 12,840 credit unions, have assets of less than $1 million and average approximately 400 members. Of the nation's more than 20,000 credit unions, fewer than 1,500 have assets in excess of $10 million.

The number of credit unions has doubled since 1951 but has remained relatively constant for the last decade. In addition, since 1951, credit union membership has grown from approximately 5 million to more than 47 million individuals. Despite this growth, the percentage of deposits in credit unions in relation to those of all financial institutions has remained at about 4% for the last decade. This is a slight increase from the relative position in 1951.

SAVINGS AT ALL INSTITUTIONS (12/82)

	1982	1972
Commercial Banks	34.7%	38.1%
Savings and Loans	32.6%	29.3%
Mutual Savings Banks	9.1%	12.9%
Open-End Mutual Funds	4.5%	8.4%
Credit Unions	4.3%	3.1%
MMF (Non-Institutional)	10.8%	0.0%
Savings Bonds	4.0%	8.2%
	100.0%	100.0%

Credit unions were initially formed around a common bond, in part, to provide loans at a low rate. Although banks and savings and loan associations now aggressively make consumer loans, the credit union is widely recognized as one of the best sources that a borrower can turn to for low-cost loans. Despite authority to increase loan interest rates granted by P.L. 95-22, the average consumer loan rate for credit unions throughout the high-interest-rate period of 1979-82 remained well under both the legal limit for credit unions and the comparable rates charged at banks and savings and loan associations.

VOLUNTEERS

Federal and state credit unions rely heavily on the use of volunteers to run credit unions. By statute most board members and committee members may not be compensated for their service. In a recent survey required by P.L. 97-320, credit unions throughout the nation reaffirmed their commitment to the importance of the volunteer in the credit union movement. The prohibition on the payment of directors and committee members is one way in which the democratic control of credit unions is continued and ensured. Although many credit unions obviously employ professional managerial and clerical staff, approximately 6,600 credit unions (33% of all credit unions) do not have any full-time employees. These credit unions average approximately $250,000 in assets and generally offer a limited array of services to their members.

Volunteers come in many forms. Recently the manager of U.S. Steel Products Credit union provided us with several examples of personal experiences:

> "I worked periodically for one year--no salary--to help another credit union's inexperienced manager adapt to credit union bookkeeping and policy making. This was done on an advisory basis, after my regular work day.
>
> My board of directors, all voluntary, spend an average of 5 hours per week of their free time studying regulations and counseling members on their financial situations.
>
> Members with building skills have donated time and materials to repair or enhance the credit union office. Very seldom do we have to pay for maintenance work."

Another credit union manager has commented to CUNA:

> "I remember a few years back when the manager of a small credit union had a heart attack and was hospitalized. We sent help to operate the credit union for several weeks without charge so the credit union could keep its doors open."

DEMOCRATIC CONTROL/MUTUAL OWNERSHIP

Each member of the credit union has one vote regardless of the number of shares purchased in the credit union. The Federal Credit Union Act, for instance, specifically prohibits the use of proxy voting (12 U.S.C. § 1760). In the last quarter century mutual savings banks and mutual savings and loan associations have widely used proxy voting to ensure continued control of the institution. The requirements of the Federal Credit Union Act stand in obvious and stark contrast to this practice.

Credit unions encourage participation in their annual meetings. How many financial institutions do what the North Greenmount Community Development Federal Credit Union in Maryland did for its annual meeting earlier this year by notifying stockholders with names from A through F to bring desserts and from Q through Z to bring salads. That is not so unusual since credit union members are not depositors but are owners.

In the St. Mary's Bank case (1976), the 1st Circuit Court of Appeals found that the nation's oldest credit union was still a credit union despite the fact that it had no written or enforced common bond requirement for membership, made real estate loans, offered demand deposits and made a number of business loans. Specifically, the Court of Appeals concluded that the credit union, in offering such services, "still met the needs of its members for short-term loans and was a democratically controlled, cooperative, non-profit society, organized for the purpose of encouraging thrift and self-reliance among its members by creating a source of credit at a fair and reasonable rate of interest in order to improve the economic and social conditions of its members."

NOT FOR PROFIT ...

As cooperative financial institutions, credit unions have operated under the principle of "not for profit--but for service". Credit union growth through the present has come from increased member savings, not the use of undivided earnings to finance growth (see, e.g., legislative history of Revenue Act of 1951 concerning mutual savings banks).

Even though 1981 was a difficult year for credit unions, at least 1500 credit unions provided loan rebates to members. This is a partial return of interest paid by borrowing members to the members where income generated exceeds that needed for dividends and statutory reserve transfers.

We would like to provide some examples of typical credit union decisions, decisions that would not necessarily be made by other types of financial institutions.

The manager of California's Golden 1 Credit Union commented to CUNA last month:

> A recent event in California that received national attention was the possibility of the State of California issuing registered warrants (IOUs) because it was broke and the legislature failed to act on a new budget. The Golden 1 Credit Union was the first financial institution that announced it would accept the IOUs from our members (state employees) who received them as paychecks. Soon other credit unions joined in and the California Credit Union League offered special loans to

> participating credit unions. Some banks finally joined in on a restricted basis but not one of the major banks would help out. They all had the same complaint: The IOUs would only earn 5% and thus would not be profitable. The Golden 1 Credit Union was concerned about its members not having paychecks, not profit.

The historically low credit union lending rates have remained low, despite high interest rates during the past several years. Again, the manager of Golden 1 in Sacramento stated in a recent letter:

> "Our loan policies are designed for people. As an example, we loan 100% of the cost of a new or used car. We loan to people, not cars. It shouldn't make a difference whether it's new or used."

Similarly, in Port Arthur, Texas, the U.S. Steel Products Credit Union reported:

> "Our credit union operated under the state usury laws for years (maximum interest rate ceilings on loans - 12%). When these laws were changed, our board of directors could have raised rates to the allowed maximum of 18-24%. But, anticipating the economic hard times for our members, the board increased the maximum rate to 15%, only enough for us to break even.
>
> Should a borrowing member become ill or laid-off his job, causing delinquency, the credit union will bend over backwards to give that member an opportunity to catch up, refinance or extend the delinquent loan. Foreclosures and repossessions are only acted upon those members who indicate no intention of repayment."

The AAC Employees Federal Credit Union of Columbia Falls, Montana, cited a specific example of lending flexibility when its sponsoring plant experienced yet another production cutback. At a meeting of the 700 laid-off employees called by the company last month, the credit union manager reported that the local bankers stated they could only give the workers a six-month grace period at half payments before repossession or foreclosure. In contrast, the credit union had made the following decisions:

> "Our board of directors has decided that we can make extension agreements to 60 months if necessary. This is lowering the loan payments to less than half for some members. The CDI insurance and life savings insurance remains in effect. We are extending at the original contracted rate of APR. So many of our members

> have come in to cooperate with us, pleased and relieved that we care for them and their problems and are willing to work with them.
>
> We are also acting as sales intermediary, for those who wish to sell personal property such as: boats, motors, cars, and pickups. We run the ads and handle telephone calls regarding these items. The credit union is also monitoring a Barter Board, to help these people find odd jobs and earn or barter for something they need in exchange for work done.

... BUT FOR SERVICE

Long before share insurance (1970) became available to credit unions, the credit union movement banded together to form an insurance company which provided life savings insurance and loan protection insurance. These policies were then, and are today, purchased by credit unions out of the earnings of the credit union without direct cost to the member. More traditional services provided by credit unions include financial counseling and money management planning. Nearly 2 million American credit union families receive "Everybody's Money," a consumer-oriented financial magazine mailed to credit union members and paid for by their credit unions.

Credit unions help groups not currently served by a credit union to find credit union service or to start their own credit union. For example, people involved in insurance in Nevada were not served by any credit union. The Southern Nevada State Employees Credit Union in Las Vegas committed itself to assisting the chartering and management of a credit union for this group. The new Nevada Insurance Credit Union was chartered in June 1982 and is located in the office of the Southern Nevada State ECU, operates on the sponsoring credit union's in-house system as a separate entity, and is staffed with the personnel of the sponsoring credit union. As of February 1983, the Southern Nevada State ECU has not realized any income for its assistance since the Nevada Insurance CU is not yet in a position to pay its fair share for services rendered.

Just so the Committee will understand that there is nothing unique about the Nevada experience, we would like to cite a similar example from Lawton, Oklahoma. The manager of the Lawton Teachers Federal Credit Union received a call in 1981 from an employee of the local Goodyear plant inquiring as to how to organize a credit union. The credit union manager started meeting with some of the Goodyear employees at night and on Sundays helping them to start the credit union, and, once started, to figure their first dividend and to set up loan policies. The Lawton Teacher FCU felt that the Goodyear employees could support a credit union. The manager noted: "Even though some employees were already members of our credit union, we wanted to help them organize for the benefit of the other employees." This credit union helped to set up a competitor for its members' savings.

About 75% of the nation's 21,400 credit unions have less than $2 million in assets. Many of these operate with volunteer or paid part-time staff. Small size requires ingenuity in providing services to members. One example of the unique credit union response to facing up to the limitation of size is the case of four credit unions in Springfield, Ohio. Each of the four credit unions have well under $2 million in assets. They have an arrangement where they share the same building, equipment and staff. Each credit union has retained its own board of directors, credit committee and supervisory committee. Each credit union has counter space and its own display board in the shared lobby. Each credit union handles its own publicity and provides its own stationery. The tellers are all trained to serve members of all four credit unions. By sharing, the credit unions are able to provide full five-day-a-week service, which the individual small credit unions could not have done.

Large credit unions help small credit unions by giving them research and advice without charge to get started, and by providing training. One credit union manager cited the example of, when trying to develop an individual retirement program with the most advantageous dividend compounding schedule for his members, calling "another credit union, with no personal relationship to or knowledge of any employee there" to ask for data processing assistance and he got the asked for assistance.

CHANGING MEMBER NEEDS

Credit unions were originally formed to provide members not only a place to save but low-cost small loans. As consumers, credit union members began to find financial services, such as transaction accounts and mortgage loans, available to them at other financial institutions. Without changing the structure or philosophy of credit unions, members asked why they should be denied these consumer financial services at their credit union. In 1977 and

1980, credit unions received the right to provide their members transaction account services, longer-term loans and home mortgages.

Credit unions, however, did not become banks. Lending is still restricted to members. Although credit unions are authorized a fairly broad range of consumer lending powers, the credit unions offer only those loan services sought by their members. Only a very small percentage of credit unions engage in mortgage lending. Fewer than 3,600 offer share draft accounts. About 200 offer credit card or debit card services. Clearly, credit unions remain a reflection of their members' wishes.

It is also important to note that in seeking transaction account authority, credit unions sought interest-bearing transaction accounts (not demand deposits not paying interest). The share draft program which began in 1974, under a regulation issued by the National Credit Union Administration, was declared invalid by a court after bankers sued to enjoin the activity. Congress ultimately recognized the validity of interest-bearing transaction accounts for consumers and authorized credit unions to offer them in P.L. 96-221.

Similarly, the credit union experience in mortgage lending has been quite different than that of other financial institutions. Authorized for the first time in 1978, one credit union has granted more than 2,000 real estate loans. To date, despite adverse economic conditions, it has had only one foreclosure. This experience stands in stark contrast to the experience of other lenders under similar circumstances. We believe it reflects a greater sense of loyalty to the credit union as a financial institution by the member and, most importantly, a willingness on the part of the credit union to work with members to help them prevent, avoid and ride through rough economic times.

As previously stated, credit unions do not serve corporations. For banks and, to a growing degree, for savings and loans and mutual savings banks, this aspect of their financial business has become increasingly important. Faced with the legislative opportunity to seek to serve these corporate interests, credit unions chose to reaffirm their dedication to their consumer-members. In a world of homogenous financial institutions, credit unions have chosen to be different. In so doing, they have remained the same.

TAXATION OF OTHER FINANCIAL INSTITUTIONS

Competitive Equality. There appears to be an underlying assumption that commercial banks, mutual savings banks, savings and loan associations and credit unions should receive the same tax treatment because they are all financial intermediaries. The credit unions' preferred tax status is seen as an unfair advantage because of its impact on the "bottom line" of the financial statement. The "bottom line" shows the net earnings after taxes. That is what is left to plow back into the business and pay dividends to shareholders for the use of their money. Every dollar saved in taxes falls through to the "bottom line." Thus, according to this argument, credit unions have higher net earnings on the bottom line to return to shareholders in the form of higher dividend rates. Similarly, the higher earnings potential permits credit unions to charge lower rates on loans and to pay higher rates on savings.

The argument is short sighted. The tax treatment of credit unions is only one form of federal subsidy available to financial institutions. A true estimate of the value to credit unions of their tax treatment must be judged in comparison with all of the other devices available to other financial intermediaries that increase their "bottom lines."

Markets Served. Credit unions, commercial banks, mutual savings banks and savings and loan associations operate in the financial services market. This market is broad and diverse. It is serviced by an almost endless variety of competing businesses, including insurance companies, investment advisors, investment funds, mortgage companies, stock brokers, underwriters, trust managers, leasing and factoring companies, finance companies, savings banks, commercial banks, savings and loan associations, credit unions, note and equity issuers, and various government agencies.

Few of these businesses serve the entire spectrum of financial services markets. As we have already pointed out, credit unions are significantly limited in the market they serve by their common bond requirement. Commercial banks and bank holding companies are obviously key participants at the domestic and international level, providing a broad range of tax-favored services as well sale of certificates of deposit, commercial paper, capital notes and debentures, the purchase of Eurodollars and Federal funds, the offering of commercial loans, corporate trust services, investment advice and consulting, the sale and purchase of government and municipal obligations, the furnishing of lock boxes, payroll and other cash management services, and many other services. Savings and loan associations and mutual savings banks are becoming active participants not only in the retail consumer market served by credit unions, but also the wholesale market. For instance, on March 8, 1983, fourteen savings and loan associations announced formation of a syndicate to make long-term loans to businesses. Credit union participation in the sale of financial services when compared to that available to other financial intermediaries is quite limited.

Subsidies. In evaluating the impact of the existing tax structure on the "bottom line" of all financial intermediaries, not only must the market served be considered, but the also availability of other federal subsidies. Using the definitions and categories of various federal subsidy programs established by the Joint Economic Committee Study on Federal Subsidies, we suggest that there are no basic differences among financial institutions in the availability of: (1) direct cash, (2) credit, (3) benefit-in-kind, (4) purchase, and (5) regulatory subsidies. Credit unions do receive space in federally buildings, but now generally pay rent for that space. Banks operating on some military reservations receive cash reimbursement for losses incurred in operating certain facilities. Guaranteed and insured loans are available to both banks and credit unions. Banks do receive a greater value since many of these benefits are available for real estate and commercial loans. In the regulatory area, commercial banks have a monopoly on demand deposit accounts.

The primary non-cash-type subsidy--the tax expenditure, tax subsidy or tax incentive--is granted through the federal income tax system in the form of exclusions, exemptions, deductions, credits, preferential rates and deferrals.

Government figures indicate that the current annual tax subsidy available to credit unions due to their tax-exempt status ranges from an OMB high estimate of approximately $225 million to a Congressional Budget Office figure of approximately $115 million. We do not know what assumptions about tax planning by credit unions were made by either group. Banks, which are nominally subject to a corporate tax rate of 42%, have effectively reduced that rate dramatically.

In the final analysis, the question of tax preferences, subsidies and exemptions is one of tax policy. We submit that the evidence shows that the tax policy reasons for originally treating credit unions separately from other financial institutions are still valid. Unlike the mutual savings banks and the savings and loan associations in 1951, credit unions have not become institutions indistinguishable from a bank, even though credit union powers have expanded in recent years. In fact, credit unions continue to share common features with other tax-exempt organizations that justify the continuation of the exemption.

EXEMPTIONS OF OTHER ENTITIES

At the end of 1982, there were 23 different categories of exemptions under Subchapter F of the Internal Revenue Code. There were, at the end of FY 1980, some 850,000 organizations exempt under those categories. There are common characteristics underlying the tax treatment of these organizations. Almost all can be viewed as having a public purpose.

It is difficult to categorize the types of exempt organizations. However, generally they might be categorized as follows:

(1) Mutual protection and benevolent societies. Examples include religious and charitable organizations, social welfare, social and recreational, fraternal, local benevolent life insurance associations, cemetery companies, and mutual insurance companies.

(2) Related to governmental activities. Educational and scientific organizations, civic leagues, business leagues, chambers of commerce and boards.

(3) Employee related. A surprising number of the exempt organizations are employee- or occupationally-related. These include voluntary employee beneficiary associations, teacher retirement fund associations, supplemental unemployment trusts, employee-funded pension trusts, prepaid legal service funds.

(4) Agricultural. These include: agricultural and horticultural orgnaizations, telephone organizations, cooperatives to finance crops and farmer co-ops.

COMMON CHARACTERISTICS

Non-profit. With one or two exceptions, all of the organizations exempt under section 501 of the Tax Code are non-profit. When referring to "non-profit" forms of enterprise that are exempt from taxation, reference is generally to the fact that there is no entrepreneurial profit in credit unions or, in most other cases, of tax-preferred entities. Funds are not invested to create returns for the investor through sales to the general public. Members of these organizations do not deal with the general public and so, usually, the benefits are limited to members.

Membership. Many of the tax-exempt entities are membership groups. There is usually a bond or affinity of some kind. It may be employment, religion, occupational or fraternal.

Credit unions are membership groups, and there are qualifications that must be met before a person can join. Those qualifications include being within the field of membership (common bond) specified in the charter issued by the National Credit Union Administration or a state-chartering authority. Our analysis indicates that the common thread between mutual organizations that are exempt from taxation has to do with its membership quality, not any other aspect of ownership.

Size. There is no doubt that size is an element upon which the tax exemption rests. Existing tax law specifies that mutual insurance companies cannot have a gross income exceeding $150,000 to qualify for the section 501(c)(15) status. For the most part, credit unions certainly are small in relationship to business enterprises. They are definitely small in relation to the financial services market.

Employee Related. A thorough review of tax-exempt organizations reveals that many of the exemptions apply to entities with membership based on employee or occupational criteria. A list includes: federal credit unions, 501(c)(1); local associations of employees, 501(c)(4); labor organizations, 501(c)(5); voluntary employee beneficiary associations, 501(c)(9); teacher retirement fund associations, 501(c)(11); state credit unions, 501(c)(14); supplemental unemployment trusts, 501(c)(17); employee-funded pension trusts, 501(c)(18); pre-paid legal service funds, 501(c)(20); black lung benefit trusts, 501(c)(21); farmer cooperatives, section 521(a). Nearly 80% of the nation's 20,000 credit unions have employment-related fields of membership.

Comment: Credit unions fit in with the group of member benefit tax-exempt organizations listed in section 501(c). They have a cluster of characteristic of the others. For policy reasons, Congress has consistently adopted exemptions for these non-profit membership organizations. We believe that in addition to all of the traditional reasons given for preserving the tax exemption of credit unions, this exploration of the similarities with other tax-exempt organizations supports the continued tax treatment for credit unions.

STATUTORY RESERVE REQUIREMENTS

Statutory reserve requirements are unique to credit unions. Banks and savings and loan associations do not have to set aside an amount required by statute for loan losses and other losses. The Federal Credit Union Act (12 U.S.C. § 116), for instance, requires that federal credit unions establish and maintain a regular reserve to which losses on uncollectible loans and other losses as specified by the National Credit Union Administration will be charged. If Congress were to decide that it was necessary to subject credit unions to federal income tax (credit unions do pay tax on personal and real property), coordination between the tax writing and banking committees of Congress would be essential in developing a tax formula so as not to undermine the stability of credit unions.

In 1978 the Carter Administration proposed to eliminate credit union's exemption from federal income tax. Under that proposal, credit unions would have been permitted to reduce gross income by all operating expenses and dividends to shareholders. This net income would then be reduced by a bad debt deduction, which would be phased down, in effect, from 100% to 30% of net income over a five-year period (the 30% deduction would be the same deduction allowed savings and loan associations and mutual savings banks). The remaining amount would be taxed as corporate income. The following example illustrates the serious problem which would be created for a credit union under the Carter Administration formula:

Illustration: A credit union with gross income of $103,000, operating expense of $44,000, dividend distribution of $43,000, and a statutory reserve requirement of 10% (because it has not reached the 4% reserve level required) would receive the following treatment:

Gross Income	$103,000
Operating Expense	44,000
Dividends Paid	43,000
Net Income	$ 16,000
Statutory Reserve Required	$ 10,300*
Bad Debt Reserve Deduction	4,800**

* 10% of Gross Income
** 30% of Net Income

Thus the credit union would be required to contribute $10,300 to its statutory regular reserve account, and yet would be permitted a deduction of only $4,800. This example demonstrates the unfairness credit unions would face by having to pay a tax on amounts that are required to be retained by statute.

The only options available to accommodate the imposition of such a tax would be to raise loan rates, lower dividends, narrow the operating spread and transfers to reserves where possible, and finally, deviate from our statutory purpose of providing loans to members by investing in tax-sheltered obligations or tax-preferred investments. These alternatives do not square with the credit union tradition--"not for profit, but for service."

CONCLUSION--CREDIT UNIONS ARE DOING THEIR JOB

Credit unions continue to be unique financial institutions. Credit unions remain mutually-owned, non-profit, cooperative, democratically controlled financial institutions whose members share a common bond. The vast majority are small and, by statute, most board and all committee positions are staffed by volunteer personnel. Credit unions lend only to their members and continue to pay an attractive rate of return on members' savings. This carries forth their two statutory purposes of providing loans for provident and productive purposes and promoting thrift.

CUNA's analysis of credit unions has shown that they continue to share with other tax-exempt organizations characteristics of size; membership requirements; a close relationship, in many instances, to employment; and they remain, in the literal sense of the word, non-profit institutions.

As it was in 1937, it is still the case that "federal credit unions are mutual or cooperative organizations, operated entirely by and for their members...." The reasons Congress relied upon to justify the special tax status of credit unions in 1937 and in 1951 are still valid policy in 1983.

The CHAIRMAN. Mr. Roth.

STATEMENT OF ARTHUR T. ROTH, CHAIRMAN OF THE BOARD OF THE NATIONAL TAX EQUALITY ASSOCIATION

Mr. ROTH. Mr. Chairman, I am Arthur T. Roth. I am chairman of the board of the National Tax Equality Association. My remarks are going to be in three areas: Withholding on interest and dividends, credit unions, and all mutual type organizations.

Mr. Chairman, it was 1963 that I appeared here before Senator Douglas discussing withholding on interest and dividends. It was a subject I did not bring up, but it was brought up by Senator Douglas, who was the chairman. I discussed other matters of inequality in taxation.

Senator Douglas, in introducing me, said that I was one of three bankers in the United States that he knew of that stood up for the withholding on interest and dividends. He said it was unfortunate that the bill did not go through, and he hoped that some years later it would be enacted. I said to Senator Douglas, but, Senator Douglas, because of the good fight that we put up, we caused banks to file 1099 forms which were sent to all recipients of interest and dividends. And of the lower percentage of taxes that were received on interest and dividends, it increased very substantially. Oh, said Senator Douglas—and I remember his remarks very well, and I will read them to you—it is in his testimony—he said, "In other words, Mr. Roth, that was a sacrifice fly which brought home the run from third base." Well, it didn't quite bring the run home from third base. The information that we get from the IRS is to the effect that as of 1981, approximately 97.3 percent of the income that was to be collected, as shown by form 1099, was being received, 97.3 percent. Now, in inquiring of the IRS how they arrived at this figure, we found that they totaled up all of the 1099 forms and then compared that with the amount shown on the income tax 1040 forms, and they came up with a figure of 97.3 percent. I believe that that figure is too high and it should be in the neighborhood of 95 percent. But even 95 percent collection is pretty good. But I think it should be better than 95 percent. It should be closer to 100 percent. And I believe that a few changes should be made to sharpen the tools that we already have which will bring it close to a hundred percent without the need for all of the work that is necessary in connection with the 10-percent program on withholding on interest and dividends.

We have given you a form, a 1040 form, and in schedule E I believe it is on the 1040 form—no, schedule B. You will notice on schedule B—do you have it before you, Senator?

The CHAIRMAN. Yes.

Mr. ROTH. You will notice under interest we have inserted the words as listed on form 1099. And then we say list interest to correspond with form 1099. And below that there should be added interest received without form 1099. In other words, what a great many taxpayers are doing today is not listing these items individually but they are bulking it. And we cannot check the 1099 forms against the income tax returns. There should be cross-checking.

And if we had cross-checking, I think that our income would be increased considerably. But cross-checking is necessary.

Now, when 1099 came into being 20 years ago as a result of this here effort that was made, when it came into being at that time, all of these forms were sent to the IRS. I guess they would fill a room about the size of this room. Well, I don't know what IRS did with them. I think they sent them to the Archives the 1st year, the 2d year, the 5th year, the 10th year. It is only in the last few years they are doing some cross-checking. The banks have done their jobs. They have sent in the 1099 forms religiously, but the IRS has been unable to cope with all of these forms to cross-check. And I think that if they did their cross-checking we would get close to a 100 percent, and there would be no need for withholding.

Furthermore, as I look at the 1099 forms that are being used today—I think you have a half a dozen that I received myself. They are samples of them—you will find that there are all kinds of forms, and there is no legend on there really strong enough to indicate to the taxpayer that he had better report the income shown on the 1099 form. And I think that the 1099 form should be changed and strengthened. With those two matters, I think we can completely do without the withholding program.

Second, with regard to credit unions.

The CHAIRMAN. You will have to summarize because we have some other witnesses.

Mr. ROTH. Yes. I won't say anything more than for 15 years we have been testifying to try to get some taxes on credit unions. It is high time that they were taxed. They have gotten to be large institutions. They have no excuse for their not paying tax.

The third item with regard to mutual type organizations. I think we are missing the boat with regard to mutual type organizations. They have nonownership wealth consisting of surplus funds that really do not belong to anyone. And I would put the credit unions in that category, too, pretty much. And I think that we ought to cause them to be converted into stock ownership corporations, and that the cost of converting them into stock ownership corporations I think the Government should be entitled to, escheat, all of that portion of the surplus funds which were accumulated by people who have since died or closed their accounts. And I think that is a tremendous source of income for the Government. I might say about that, I introduced legislation along those lines in the New York State Legislature 25 years ago, and David Rockefeller came up to me and he said, "Arthur, that's pie in the sky." I said "There has to be a beginning". Right now, all the savings banks in New York State do want to convert into stockholder owned corporations, and they are taking steps to do it. But nothing is being done to permit the escheating of part of those surplus funds to the U.S. Government or to the State under which they were organized.

Thank you, sir.

The CHAIRMAN. Thank you very much, Mr. Roth. We appreciate it.

[The prepared statement of Arthur T. Roth follows:]

STATEMENT OF ARTHUR T. ROTH
THE BANKERS COMMITTEE FOR TAX EQUALITY
SUMMARY OF TESTIMONY

Our testimony before the Senate Finance Committee covers two subjects of interest to these hearings on financial institutions taxation. The subjects include provisions to collect revenues due on interest and dividends without the implementation of withholding requirements and the continuing income tax exemption of credit unions.

It is important to realize that opposition to withholding is based not only on the problems financial institutions and their customers anticipate because of the new provisions, but because there exist reasonable alternatives to ensure that taxes on interest and dividends are collected.

Extensive computer cross-checking of Form 1099 with tax forms, application of 1099 forms to government securities and similar investments and efforts to better inform taxpayers of their obligations will result in severely limiting tax evasion and subsequent loss of revenues.

The Bankers Committee suggests the following procedures to better inform taxpayers of their responsibilities concerning interest and dividend taxes. First, all taxpayers who receive interest and dividend income shall be required to file a schedule B form thereby itemizing the amount of interest and dividend income and the payer of such income. Second, certain changes and additions to 1040 and 1099 forms would be made to ensure that the taxpayer includes all sources of interest and dividend income and is aware that the IRS has and will utilize corresponding forms and information.

These suggestions, together with the enforcement procedures adopted by the Tax Equity and Fiscal Responsibility Act of 1982, will provide the necessary compliance to collect the revenues now expected from withholding but without the negative effects associated with the controversial procedure.

Our second subject of concern pertains to the continued income tax exemption for credit unions. Because the effective tax rate for the nation's mid-sized and smaller banks is considerably higher than the largest institutions in the country, the income tax exemption for credit unions is an important issue to competing institutions.

Over the years, the characteristics of credit unions that were originally income tax exemption qualifications, have practically disappeared. Generally they included a limited membership to individuals with close relationships such as place of employment, or some similar association. Additionally, credit unions were to provide opportunities for credit to those otherwise not able to obtain financing because of low income. In 1977, two events transpired that greatly altered the characteristics of credit unions: Congress granted increased powers in both lending and saving, and a federal appeals court held that an institution may qualify as a tax exempt credit union whether or not membership requirements such as employment qualifications exist.

While these developments diminish the unique qualities of credit unions, they serve to increase the effectiveness of the institutions in the marketplace. In 1981, there were 21,000 credit unions with total assets exceeding 80.6 billion dollars. Were these thriving institutions to contribute to the federal income tax base, the Joint Committee on Taxation estimates enhanced revenues of 115 million dollars in 1983 and 140 million dollars by 1987 -- obviously, a substantial contribution to the effort to decrease our increasing federal budget deficit.

I ENFORCEMENT PROVISIONS FOR ADEQUATE COLLECTION OF INTEREST & DIVIDEND TAXES WITHOUT WITHHOLDING REQUIREMENT

Mr. Chairman, the Bankers Committee for Tax Equality appreciates this opportunity to testify before the Senate Finance Committee. Today's hearings on the taxation of financial institutions provide the opportunity to review the tax code and hopefully establish policies that may improve the fairness of the code as well as enhance revenues. In light of the serious deficit problem confronting our federal government, we would have to agree that certain actions must be taken to close loopholes and raise revenues. We have selected two issues of priority to discuss today. The first pertains to the withholding provisions of the Tax Equity and Fiscal Responsibility Act of 1982.

We believe that there is a better simpler method to achieve the results which are proposed by the withholding method on interest and dividends. This better method is the proper use of reporting forms and improved reporting procedures which will greatly increase compliance.

Extensive computer cross-checking between 1099 forms and tax returns and expansion of the use of 1099 forms to cover U.S. government securities and similar investments will contribute to increased compliance. Additionally, we would suggest procedures to better inform the taxpayers as to their tax obligations concerning interest and dividend income. This could be accomplished by requiring itemization of interest and dividend income with the attachment of a Schedule B for all 1040 and 1040EZ forms reporting interest and dividend income. (Currently the 1040A form, Part I and Part II of the second page, provides for the itemization of interest and dividend income) We would also suggest a similar schedule attachment and itemization procedure for any fully taxable pensions, IRA distributions and annuities. Margin insertions would be added to the Schedule B to notify the taxpayer that he must list income and dividends to conform to form 1099 and any other interest and dividend income not reported by a form 1099. Another procedure to increase taxpayer compliance recommended by the Bankers Committee for Tax Equality would involve informing taxpayers of IRS "form cross-checking" on interest and dividend income with a notice to be included on all 1099 forms.

The above procedures can practically eliminate cheating without the additional cost and paperwork of withholding, without discouraging the American people from saving and investing and without punishing the majority of Americans who pay their taxes in full.

We are assured that this can be accomplished by the July, 1981, report issued by the IRS that found 97.3% compliance in regard to interest and dividend income taxes when information returns are filed and matched with returns filed by taxpayers.

Combining the above mentioned procedures with the positive changes recently made by TEFRA such as new and stiffer penalties for failure to file usable information returns will accomplish the revenue levels expected by withholding without the many problems associated with withholding.

II ELIMINATION OF TAX EXEMPTION FOR CREDIT UNIONS

Mr. Chairman, the second subject I am going to speak on pertains to the continuing income tax exemption for credit unions.

As a recent study indicates, the effective tax rate for smaller community banks and mid-sized banks differs considerably from the tax rate of the large institutions usually examined in tax rate studies. This means the exemption for credit unions remains an important issue to smaller and mid-sized banks which, incidentally, comprise the largest portion of the banking industry. The study I refer to was conducted by Tax Analysts, an independent research firm. In 1981, the research group released figures on the nation's largest twenty banks, with an average effective tax rate for the banks of negative 12.6%. After complaints from many banking representatives, Tax Analysts agreed to study mid-sized banks and found an average rate of taxation of 13.8%. Considering that these banks are encouraged by the federal government to invest in tax-exempt state and local bonds and required to deposit funds interest free at the Federal Reserve, the gap between the rate most banks pay in taxes and the national average tax rate of

20.6% for domestic corporate income is minimal.

In comparison, institutions organized as credit unions, competing with commercial banks, remain tax free. The credit union tax exemption was designed to assist these financial institutions when they were providing credit to those not otherwise able to secure financing because of low income, but the credit union exemption continues even though their operations have been expanded by offering various banking services resulting in large numbers of new members with average and above average incomes.

As the facts indicate, the expansion of the credit union industry has been significant. Legislation enacted in 1977 (P.L. 95-468) allowed credit unions increased powers in both lending and saving, greatly stimulating the growth of the industry. During the decade of the 1970's, total assets of Federal credit unions increased more than 4½ times to a total of 36.5 billion dollars. By the year 1981, 21,000 Federal and State credit unions were active with total assets exceeding 80.6 billion dollars.

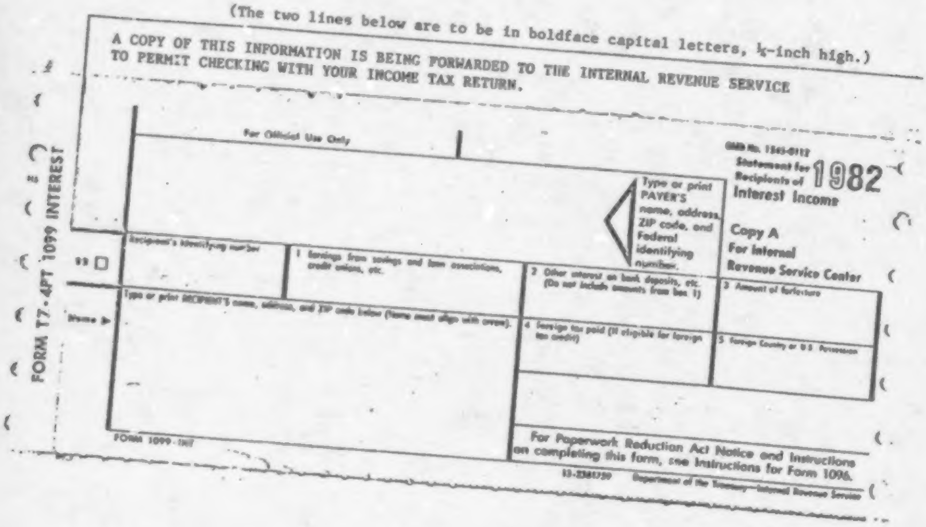
Obviously, this growth translates into lost customers for other financial institutions, but not only is the development of tax-free credit unions a problem for competing institutions, but it is also a problem for the U.S. Treasury. According to the Joint Committee on Taxation, the credit union exemption will cost the Treasury 115 million dollars in 1983 and 140 million dollars by 1987.

While revenue loss is one reason to repeal the exemption, another concern is the deterioration of the "mutuality of ownership" concept and the "common-bond" principle. Recently, the principle of "common-bond" has expanded to the point that minimal requirements such as state residency are all that is required to fulfill the legal obligation of the concept.

In 1977, a Federal appeals court held that an institution may qualify as a tax exempt credit union if most depositors have "similar characteristics" whether or not membership requirements such as employment qualifications exist. La Caisse Populaire Marie v U.S., 563 F. 2d 505 (1st Cir. 1977)

In summary, I believe the statement of the Honorable Michael Blumenthal, former Secretary of the Treasury, before the Ways and Means Committee on January 30, 1978, persuasively argues our position. "The exemption from taxation for credit unions is an anachronism. Credit unions were exempted from taxation in the days when these institutions were small entities with close bonds among the members and few powers to provide extensive financial services. Today, many have expanded to the point where they are functionally identical to and compete with savings and loan associations and commercial banks."

THESE COPIES OF FORM 1099 AND SCHEDULE B REFLECT CHANGES PROPOSED BY THE BANKERS COMMITTEE FOR TAX EQUALITY



(The two lines below are to be in boldface capital letters, ¼-inch high.)

A COPY OF THIS INFORMATION IS BEING FORWARDED TO THE INTERNAL REVENUE SERVICE TO PERMIT CHECKING WITH YOUR INCOME TAX RETURN.

FORM T7-4PT 1099 INTEREST

For Official Use Only

Type or print PAYER'S name, address, ZIP code, and Federal identifying number.

OMB No. 1545-0112

Statement for Recipients of **1982**

Interest Income

Copy A

For Internal Revenue Service Center

Recipient's identifying number

☐

1 Earnings from savings and loan associations, credit unions, etc.

2 Other interest on bank deposits, etc. (Do not include amounts from box 1)

3 Amount of forfeiture

Type or print RECIPIENT'S name, address, and ZIP code below (Name must align with arrow).

Name ▶

4 Foreign tax paid (If eligible for foreign tax credit)

5 Foreign Country or U.S. Possession

FORM 1099-INT

For Paperwork Reduction Act Notice and Instructions on completing this form, see Instructions for Form 1096.

[illegible] Department of the Treasury—Internal Revenue Service

Schedules A&B (Form 1040) 1982

Schedule B—Interest and Dividend Income

OMB No. 1545-0074

Page 2

Name(s) as shown on Form 1040 (Do not enter name and social security number if shown on other side)

Your social security number

Part I
Interest Income

(See pages 8 and 20 of Instructions.)

Also complete Part III if you received more than $400 in interest.

List
interest
o correspond
ith Form 1099

List
interest
not reported
with Form 1099

If you received more than $400 in interest or you received any interest from an All-Savers Certificate, you must complete Part I and list ALL interest received. If you received interest as a nominee for another, or you received or paid accrued interest on securities transferred between interest payment dates, please see page 20.

Interest income other than interest from All-Savers Certificates		Amount
1 Interest income from seller-financed mortgages. (See Instructions and show name of payer.)	1	
2 Other interest income (list name of payer)		
3 Add lines 1 and 2	3	

Interest from All-Savers Certificates (ASCs). (See page 21.)		Amount
4		
5 Add amounts on line 4	5	
6 Write the amount of your ASC exclusion from the worksheet on page 21 of Instructions . . .	6	
7 Subtract line 6 from line 5	7	
8 Add lines 3 and 7. Write your answer here and on Form 1040, line 8 . . . ▶	8	

Part II
Dividend Income

(See pages 9 and 21 of Instructions.)

Also complete Part III if you received more than $400 in dividends.

List
dividends
o correspond
ith Form 1099

List
dividends
ot reported
ith Form 1099

If you received more than $400 in gross dividends (including capital gain distributions) and other distributions on stock, or you are electing to exclude qualified reinvested dividends from a public utility, complete Part II. If you received dividends as a nominee for another, see page 21.

Name of payer, as listed on Form 1099				Amount
9				
10 Add amounts on line 9			10	
11 Capital gain distributions. Enter here and on line 13, Schedule D.*	11			▨
12 Nontaxable distributions. (See Instructions for adjustment to basis.) .	12			▨
13 Exclusion of qualified reinvested dividends from a public utility. (See Instructions.)	13			▨
14 Add lines 11, 12, and 13			14	
15 Subtract line 14 from line 10. Write your answer here and on Form 1040, line 9a . . ▶			15	

**If you received capital gain distributions for the year and you do not need Schedule D to report any other gains or losses, do not file that schedule. Instead, enter 40% of your capital gain distributions on Form 1040, line 14.*

Part III
Foreign Accounts and Foreign Trusts

(See page 21 of Instructions.)

If you received more than $400 of interest or dividends, OR if you had a foreign account or were a grantor of, or a transferor to, a foreign trust, you must answer both questions in Part III.	Yes	No
16 At any time during the tax year, did you have an interest in or a signature or other authority over a bank account, securities account, or other financial account in a foreign country?		
17 Were you the grantor of, or transferor to, a foreign trust which existed during the current tax year, whether or not you have any beneficial interest in it? If "Yes," you may have to file Forms 3520, 3520-A, or 926		

For Paperwork Reduction Act Notice, see Form 1040 Instructions.

The CHAIRMAN. Mr. Welsh and Mr. Hutchinson, you have heard the testimony of the Treasury witness, I believe, this morning, that the exemption for credit unions is outdated because, among other reasons, credit unions compete directly with taxable thrift institutions and have begun to cater to higher income members in the shift to loan and financing activity, including real estate lending. Your testimony does not describe the portfolio investments of the largest 200 to 500 credit unions to substantiate claims that credit unions are different. And I am not asking you to try to provide all that information today, but it would be helpful to our staff if you could respond to the Treasury comment. I don't know where this came from. The hundred largest credit unions with assets of nearly $1 billion. Now, they don't sort of fit into the testimony there of the volunteers and the 5 hours spent somewhere. We are not totally blind here.

Mr. HUTCHINSON. Mr. Chairman, I think, looking at the figures, of course, they are large associations and they do have large amounts of dollars. Each of those individual credit unions are run by a volunteer board of directors and volunteer committees. They still are practicing the fundamental charge that was given to them by Congress in the very beginning. All of the earnings that the credit union will receive are distributed back to the membership.

I have a question, Mr. Chairman, in regards to that distribution of the taxation of those funds. Listening to the testimony here this morning, and listening to the percentage of taxes that have actually been paid by those that are already being taxed, I wonder if the following question is appropriate. If we were to tax credit unions on the top—let's say on gross income—rather than tax them as they are now being taxed by the individual paying taxes on their earnings, would not the Government be getting less rather than more? Taxation on the gross income, if it was in the same ratio as the taxes that are being paid by other types of institutions as testified to here today, would be a much smaller percentage than the level of taxation that individuals pay on their income tax.

The CHAIRMAN. Do you make distributions?

Mr. HUTCHINSON. Yes. The distribution now is taxed to the individual. It seems to me the testimony we heard today was that the individual pays anywhere from a 20- to a 40-percent tax rate, which is a lot higher than the corporate tax rate or the actual tax rate the Government is realizing.

The CHAIRMAN. Well, we will be glad to look at that. But the effective tax rates are different for different businesses and different institutions, and that is the thing we are trying to focus on. Are the rates fair? And I am not suggesting the effective tax rate tells you everything. Obviously it does not. But there is a perception there, where you are totally tax exempt or when your are paying a 2.7-percent point rate, and most businesses are paying 20 to 40 percent, and a lot of individuals are paying in that range. But there is something not quite right about a billion dollar organization that doesn't pay any taxes. Now, maybe we don't understand it, as you have indicated, but I am not certain how many would if they just looked at the raw numbers. I understand something about the credit union. I don't have any quarrel with credit unions. But it just seems to me that—you indicate, or Mr. Welsh did, about how the credit unions are controlled by their depositors—I wonder how many members of the Pentagon and Navy Credit Union attended their most recent meetings, and what percentage of the members that was. I mean, do you keep a record of all this voluntarism and participation?

Mr. WELSH. Well, Mr. Chairman, those records certainly have to be kept because the credit union is a nonprofit organization owned by those members. And all of those members would be impacted by any tax that would be imposed on the credit union because they are the consumer owners. And those records are kept. And I am sure that they are necessary for the committee's consideration, they can be obtained and presented. We obviously don't keep records on an individual credit union. But we would be happy to do that.

The CHAIRMAN. The point is, they have some very large credit unions. You don't deny that. Aren't there some rather large credit unions?

Mr. WELSH. There certainly are.

The CHAIRMAN. They have the same structure.

Mr. WELSH. The same structure exists.

The CHAIRMAN. The same structure. The very smallest?

Mr. WELSH. Exactly the same. In fact, in the largest credit unions, the number of volunteers would be more just because they need to have more committees. And the committee members also cannot be paid. So those committees are structured the same way. They are a nonprofit organization for the benefit of the members. And I think that is the major difference in the philosophical dealings that they have with their members. If you go into Navy Federal, their members are treated the same as members in this $35,000 credit union. They may be able to get in there a lot more often than they can into the $35,000 one.

The CHAIRMAN. I think the Treasury also made a point that—the Treasury Department previously said that the credit unions no longer cater only to wage owners. And they pointed to the growing average account size of the larger credit unions. Do you agree? And if you do, can you give us figures on the growth and the different types of accounts on your large members?

Mr. WELSH. We could provide that data.

[The data follows:]

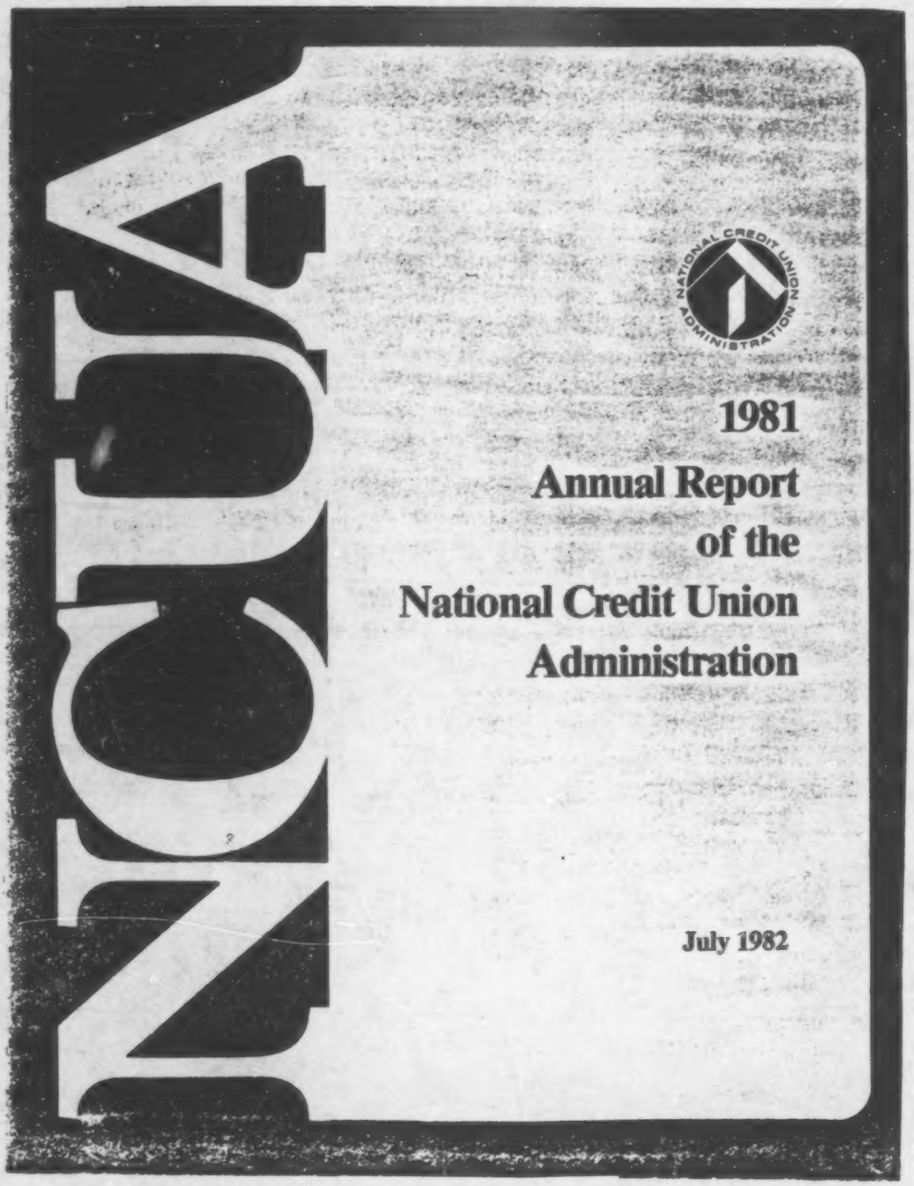


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TABLE S-19 — NUMBER AND AMOUNT OF SAVINGS ACCOUNTS AND PERCENTAGE DISTRIBUTION IN FEDERALLY INSURED STATE CREDIT UNIONS, DECEMBER 31, 1981, BY SIZE OF ACCOUNT AND ASSET SIZE OF CREDIT UNION

ASSET SIZE	SIZE OF SAVINGS ACCOUNTS						
	TOTAL	$2,000 OR LESS	$2,001-$5,000	$5,001-$10,000	$10,001-$20,000	$20,001-$40,000	$40,001-OR MORE
	NUMBER OF SAVINGS ACCOUNTS						
TOTAL	14,697,252	12,432,511	1,360,325	501,726	273,085	71,271	18,334
Less than $50,000	20,379	20,149	212	16	2	—	—
$50,000 - $99,999	48,839	47,276	1,381	159	23	—	—
$100,000 - $249,999	225,772	212,693	10,963	1,731	343	37	5
$250,000 - $499,999	387,096	353,407	27,209	5,118	1,195	173	34
$500,000 - $999,999	639,171	568,279	54,404	12,519	3,320	572	77
$1,000,000 - $1,999,999	1,017,549	891,023	92,737	23,957	8,094	1,500	238
$2,000,000 - $4,999,999	1,898,404	1,641,422	174,221	56,711	21,377	4,016	657
$5,000,000 - $9,999,999	2,082,306	1,768,134	202,510	70,526	33,012	6,827	1,297
$10,000,000 - $19,999,999	2,198,729	1,830,858	204,106	74,699	38,448	8,891	1,727
$20,000,000 - $49,999,999	3,017,879	2,542,192	268,040	120,775	65,649	16,670	4,533
$50,000,000 - $99,999,999	1,831,432	1,510,091	171,832	77,064	49,324	18,187	4,939
$100,000,000 or more	1,329,696	1,046,987	152,690	58,451	52,338	14,403	4,827
	AMOUNT OF SAVINGS ACCOUNTS (IN THOUSANDS)						
TOTAL	20,006,802	4,649,639	4,202,814	3,587,199	3,694,392	1,922,888	1,949,871
Less than $50,000	3,990	3,281	584	103	21	—	—
$50,000 - $99,999	16,364	11,104	3,878	1,077	306	—	—
$100,000 - $249,999	105,294	56,664	31,296	11,572	4,501	973	327
$250,000 - $499,999	248,295	112,979	79,342	34,577	14,897	4,461	2,038
$500,000 - $999,999	501,819	193,028	159,775	85,546	44,000	14,969	4,504
$1,000,000 - $1,999,999	914,948	310,539	278,198	164,963	107,672	39,822	13,764
$2,000,000 - $4,999,999	1,947,310	578,158	534,156	400,728	285,970	107,685	40,613
$5,000,000 - $9,999,999	2,456,982	617,207	623,467	506,321	442,869	186,348	80,770
$10,000,000 - $19,999,999	2,644,286	610,820	615,607	539,866	526,763	241,706	109,524
$20,000,000 - $49,999,999	4,440,321	1,046,003	842,510	874,233	904,636	443,074	329,866
$50,000,000 - $99,999,999	3,367,900	520,116	542,737	547,668	659,101	477,694	620,585
$100,000,000 or more	3,359,294	589,751	491,303	420,543	703,657	406,159	747,880
	PERCENTAGE DISTRIBUTION OF NUMBER OF SAVINGS ACCOUNTS						
TOTAL	100.0	84.8	9.3	3.4	1.9	.5	.1
Less than $50,000	100.0	98.9	1.0	.1	—	—	—
$50,000 - $99,999	100.0	96.8	2.8	.3	1/	—	—
$100,000 - $249,999	100.0	94.2	4.9	.8	.2	1/	—
$250,000 - $499,999	100.0	91.3	7.0	1.3	.3	1/	—
$500,000 - $999,999	100.0	88.9	8.5	2.0	.5	.1	1/
$1,000,000 - $1,999,999	100.0	87.6	9.1	2.4	.8	.1	1/
$2,000,000 - $4,999,999	100.0	86.5	9.2	3.0	1.1	.2	1/
$5,000,000 - $9,999,999	100.0	84.9	9.7	3.4	1.6	.3	.1
$10,000,000 - $19,999,999	100.0	84.8	9.5	3.5	1.8	.4	.1
$20,000,000 - $49,999,999	100.0	84.2	8.9	4.0	2.2	.6	.2
$50,000,000 - $99,999,999	100.0	82.5	9.4	4.2	2.7	1.0	.3
$100,000,000 or more	100.0	78.7	11.5	4.4	3.9	1.1	.4
	PERCENTAGE DISTRIBUTION OF AMOUNT OF SAVINGS ACCOUNTS						
TOTAL	100.0	23.2	21.0	17.9	18.5	9.6	9.7
Less than $50,000	100.0	82.2	14.6	2.6	.5	—	—
$50,000 - $99,999	100.0	67.9	23.7	6.6	1.9	—	—
$100,000 - $249,999	100.0	53.8	29.7	11.0	4.3	.9	.3
$250,000 - $499,999	100.0	45.5	32.0	13.9	6.0	1.8	.8
$500,000 - $999,999	100.0	38.5	31.8	17.0	8.8	3.0	.9
$1,000,000 - $1,999,999	100.0	33.9	30.4	18.0	11.8	4.4	1.5
$2,000,000 - $4,999,999	100.0	29.7	27.4	20.6	14.7	5.5	2.1
$5,000,000 - $9,999,999	100.0	25.1	25.4	20.6	18.0	7.6	3.3
$10,000,000 - $19,999,999	100.0	23.1	23.3	20.4	19.9	9.1	4.1
$20,000,000 - $49,999,999	100.0	23.6	19.0	19.7	20.4	10.0	7.4
$50,000,000 - $99,999,999	100.0	15.4	16.1	16.3	19.6	14.2	18.4
$100,000,000 or more	100.0	17.6	14.6	12.5	20.9	12.1	22.3

1/ LESS THAN 0.05 PERCENT

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TABLE S-23 — NUMBER AND AMOUNT OF SAVINGS ACCOUNTS AND PERCENTAGE DISTRIBUTION IN FEDERALLY INSURED STATE CREDIT UNIONS, DECEMBER 31, 1980, BY SIZE OF ACCOUNT AND ASSET SIZE OF CREDIT UNION

ASSET SIZE	SIZE OF SAVINGS ACCOUNTS						
	TOTAL	$2,000 OR LESS	$2,001-$5,000	$5,001-$10,000	$10,001-$20,000	$20,001-$40,000	$40,001-OR MORE
	NUMBER OF SAVINGS ACCOUNTS						
TOTAL	13,679,921	11,526,160	1,291,159	510,108	269,106	67,283	16,108
Less than $50,000	28,596	28,313	264	16	3	—	—
$50,000 - $99,999	50,677	48,964	1,487	192	28	5	1
$100,000 - $249,999	206,995	193,728	11,156	1,736	332	40	3
$250,000 - $499,999	376,402	340,289	27,323	7,407	1,170	183	30
$500,000 - $999,999	633,086	562,443	54,287	12,258	3,498	534	66
$1,000,000 - $1,999,999	1,029,460	897,207	96,467	25,363	8,695	1,522	206
$2,000,000 - $4,999,999	1,779,279	1,521,565	175,605	55,284	21,512	4,666	647
$5,000,000 - $9,999,999	1,904,298	1,603,824	192,644	69,265	31,243	6,274	1,048
$10,000,000 - $19,999,999	1,984,267	1,686,206	180,352	72,529	35,467	8,298	1,415
$20,000,000 - $49,999,999	2,572,749	2,117,612	262,459	110,723	62,451	16,168	3,336
$50,000,000 - $99,999,999	1,794,672	1,490,009	154,825	75,187	54,309	15,795	4,547
$100,000,000 or more	1,361,480	1,076,000	134,290	82,148	50,438	13,798	4,806
	AMOUNT OF SAVINGS ACCOUNTS (IN THOUSANDS)						
TOTAL	18,468,791	4,089,281	3,973,412	3,649,212	3,572,907	1,796,908	1,387,071
Less than $50,000	4,682	3,783	763	103	33	—	—
$50,000 - $99,999	17,277	11,288	4,207	1,240	356	139	46
$100,000 - $249,999	103,494	54,434	31,865	11,569	6,258	1,112	216
$250,000 - $499,999	244,162	106,941	79,467	36,475	15,099	4,662	1,518
$500,000 - $999,999	493,645	187,773	159,755	83,281	45,151	14,134	3,551
$1,000,000 - $1,999,999	933,262	303,586	288,462	175,242	113,443	40,375	12,154
$2,000,000 - $4,999,999	1,879,037	512,575	531,917	387,946	285,076	124,598	36,926
$5,000,000 - $9,999,999	2,275,685	541,763	588,116	493,934	421,236	169,144	61,492
$10,000,000 - $19,999,999	2,385,965	532,344	554,326	521,956	472,516	224,023	80,801
$20,000,000 - $49,999,999	3,962,343	772,471	798,674	806,095	832,501	438,599	314,062
$50,000,000 - $99,999,999	3,133,753	549,633	489,067	538,121	717,370	415,204	424,358
$100,000,000 or more	3,035,524	512,690	446,794	593,289	665,867	364,916	451,968
	PERCENTAGE DISTRIBUTION OF NUMBER OF SAVINGS ACCOUNTS						
TOTAL	100.0	84.3	9.4	3.7	2.0	.5	.1
Less than $50,000	100.0	99.0	.9	.1	1/	—	—
$50,000 - $99,999	100.0	96.6	2.9	.4	.1	—	—
$100,000 - $249,999	100.0	93.6	5.4	.8	.2	1/	—
$250,000 - $499,999	100.0	90.9	7.3	1.6	.3	1/	—
$500,000 - $999,999	100.0	88.8	8.6	1.9	.6	.1	1/
$1,000,000 - $1,999,999	100.0	87.2	9.4	2.5	.8	.1	1/
$2,000,000 - $4,999,999	100.0	85.5	9.9	3.1	1.2	.3	1/
$5,000,000 - $9,999,999	100.0	84.2	10.1	3.6	1.6	.3	.1
$10,000,000 - $19,999,999	100.0	85.0	9.1	3.7	1.8	.4	.1
$20,000,000 - $49,999,999	100.0	82.3	10.2	4.3	2.4	.6	.1
$50,000,000 - $99,999,999	100.0	82.6	8.8	4.3	3.1	.9	.3
$100,000,000 or more	100.0	79.0	9.9	6.0	3.7	1.0	.4
	PERCENTAGE DISTRIBUTION OF AMOUNT OF SAVINGS ACCOUNTS						
TOTAL	100.0	22.1	21.5	19.8	19.3	9.7	7.5
Less than $50,000	100.0	80.8	16.3	2.2	.7	—	—
$50,000 - $99,999	100.0	65.3	24.4	7.2	2.1	.8	.3
$100,000 - $249,999	100.0	52.6	30.8	11.2	6.1	1.1	.2
$250,000 - $499,999	100.0	43.8	32.5	14.9	6.2	1.9	.6
$500,000 - $999,999	100.0	38.0	32.4	16.9	9.1	2.9	.7
$1,000,000 - $1,999,999	100.0	32.5	30.9	18.8	12.2	4.3	1.3
$2,000,000 - $4,999,999	100.0	27.3	28.3	20.6	15.2	6.6	2.0
$5,000,000 - $9,999,999	100.0	23.8	25.8	21.7	18.5	7.4	2.7
$10,000,000 - $19,999,999	100.0	22.3	23.2	21.9	19.8	9.4	3.4
$20,000,000 - $49,999,999	100.0	19.5	20.2	20.3	21.0	11.1	7.9
$50,000,000 - $99,999,999	100.0	17.5	15.6	17.2	22.9	13.2	13.5
$100,000,000 or more	100.0	16.9	14.7	19.5	21.9	12.0	14.9

1/ LESS THAN 0.05 PERCENT.

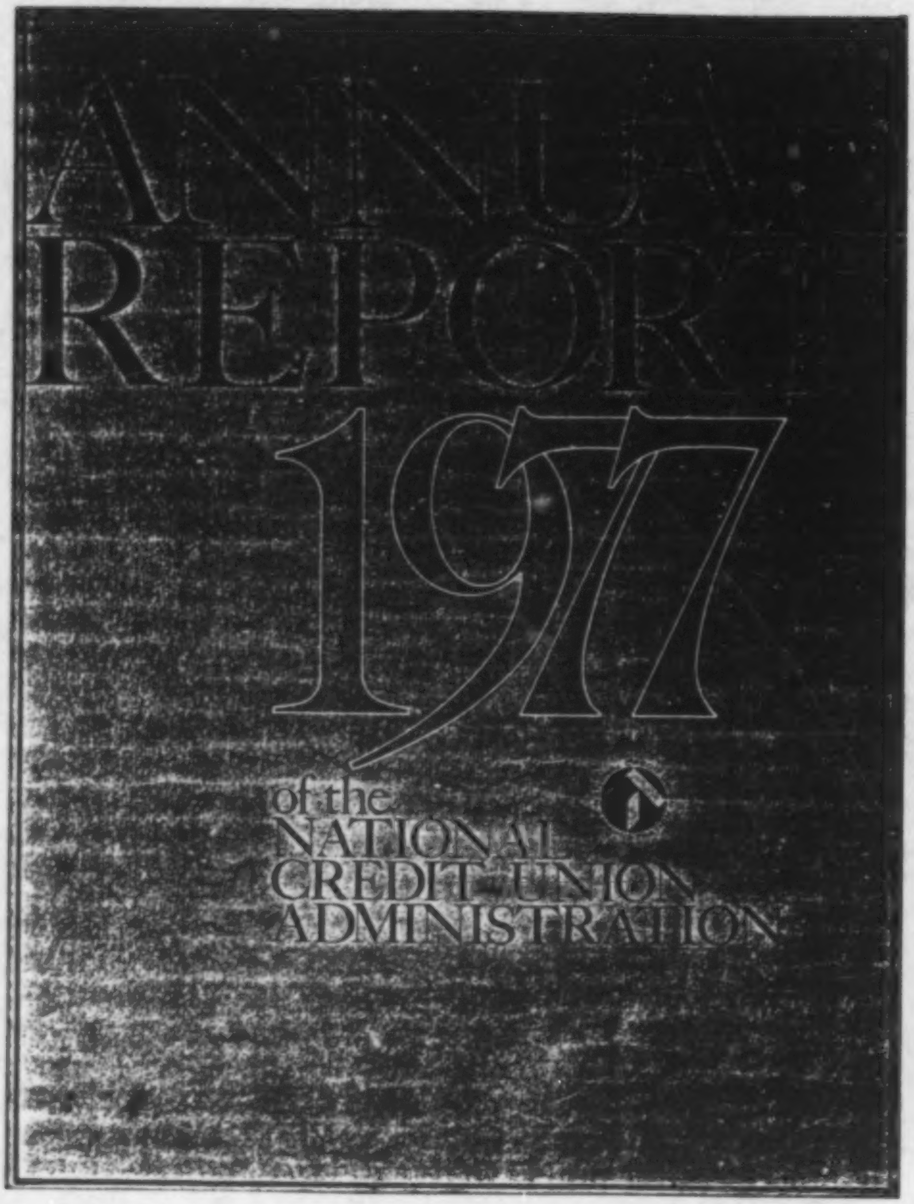
annual report 1979

national
credit union
administration

TABLE S-21 — NUMBER AND AMOUNT OF SAVINGS ACCOUNTS AND PERCENTAGE DISTRIBUTION IN FEDERALLY INSURED STATE CREDIT UNIONS, DECEMBER 31, 1979, BY SIZE OF ACCOUNT AND ASSET SIZE OF CREDIT UNION

ASSET SIZE	TOTAL	SIZE OF SAVINGS ACCOUNTS: LESS THAN $2,000	$2,001-$5,000	$5,001-$10,000	$10,001-$20,000	$20,001-$40,000	$40,001-OR MORE
	NUMBER OF SAVINGS ACCOUNTS						
TOTAL	12,218,682	10,242,313	1,212,943	467,624	223,180	63,250	9,379
Less than $50,000	25,666	25,354	283	25	4	1	—
$50,000 - $99,999	47,893	46,018	1,650	202	27	2	—
$100,000 - $249,999	199,698	185,915	11,683	1,764	284	40	9
$250,000 - $499,999	350,538	322,749	28,835	5,514	1,234	186	19
$500,000 - $999,999	606,603	535,309	54,915	12,470	3,335	501	60
$1,000,000 - $1,999,999	993,287	854,920	102,128	26,095	8,452	1,599	115
$2,000,000 - $4,999,999	1,696,122	1,440,561	175,937	54,301	20,463	4,344	519
$5,000,000 - $9,999,999	1,718,660	1,436,892	183,374	65,245	25,888	6,555	700
$10,000,000 - $19,999,999	1,936,825	1,626,273	191,846	77,199	31,948	8,311	1,254
$20,000,000 - $49,999,999	2,247,599	1,851,834	226,169	100,518	50,902	15,306	2,866
$50,000,000 - $99,999,999	1,275,967	1,034,526	120,040	63,668	43,225	12,270	2,238
$100,000,000 or more	1,111,824	881,962	116,083	60,623	37,418	14,135	1,603
	AMOUNT OF SAVINGS ACCOUNTS (IN THOUSANDS)						
TOTAL	15,871,204	3,553,619	3,724,984	3,278,310	2,991,079	1,710,704	612,503
Less than $50,000	4,598	3,561	807	161	46	22	—
$50,000 - $99,999	17,057	10,697	4,589	1,337	377	57	—
$100,000 - $249,999	99,925	50,232	33,098	11,667	3,650	1,059	219
$250,000 - $499,999	239,311	97,313	83,271	36,945	16,057	4,741	984
$500,000 - $999,999	472,255	169,977	158,907	83,983	43,275	12,963	3,149
$1,000,000 - $1,999,999	920,926	279,379	303,032	177,811	111,530	42,323	6,850
$2,000,000 - $4,999,999	1,806,947	495,828	524,824	372,337	271,732	114,524	27,701
$5,000,000 - $9,999,999	2,055,669	477,684	556,675	453,109	348,268	176,630	43,302
$10,000,000 - $19,999,999	2,398,330	530,315	589,865	543,518	430,817	221,198	82,617
$20,000,000 - $49,999,999	3,469,803	763,476	692,060	716,039	682,670	416,685	198,875
$50,000,000 - $99,999,999	2,231,114	312,756	384,424	453,182	579,577	334,182	166,994
$100,000,000 or more	2,155,267	362,402	393,434	428,221	503,080	386,320	81,810
	PERCENTAGE DISTRIBUTION OF NUMBER OF SAVINGS ACCOUNTS						
TOTAL	100.0	83.8	9.9	3.8	1.8	.5	.1
Less than $50,000	100.0	98.8	1.1	.1	1/	—	—
$50,000 - $99,999	100.0	96.1	3.4	.4	.1	—	—
$100,000 - $249,999	100.0	93.1	5.9	.9	.1	1/	—
$250,000 - $499,999	100.0	92.0	8.2	1.5	.3	.1	—
$500,000 - $999,999	100.0	88.2	9.1	2.1	.5	.1	—
$1,000,000 - $1,999,999	100.0	86.1	10.3	2.6	.9	.2	1/
$2,000,000 - $4,999,999	100.0	84.9	10.4	3.2	1.2	.3	1/
$5,000,000 - $9,999,999	100.0	83.6	10.7	3.8	1.5	.4	1/
$10,000,000 - $19,999,999	100.0	84.0	9.9	4.0	1.6	.4	.1
$20,000,000 - $49,999,999	100.0	82.4	10.1	4.5	2.3	.7	.1
$50,000,000 - $99,999,999	100.0	81.1	9.4	5.0	3.4	1.0	.2
$100,000,000 or more	100.0	79.3	10.4	5.5	3.4	1.3	.1
	PERCENTAGE DISTRIBUTION OF AMOUNT OF SAVINGS ACCOUNTS						
TOTAL	100.0	22.4	23.5	20.7	18.8	10.8	3.9
Less than $50,000	100.0	77.5	17.5	3.5	1.0	.5	—
$50,000 - $99,999	100.0	62.7	26.9	7.8	2.2	.3	—
$100,000 - $249,999	100.0	50.3	33.1	11.7	3.7	1.1	.2
$250,000 - $499,999	100.0	40.7	34.8	15.4	6.7	2.0	.4
$500,000 - $999,999	100.0	36.0	33.6	17.8	9.2	2.7	.7
$1,000,000 - $1,999,999	100.0	30.3	32.9	19.3	12.1	4.6	.7
$2,000,000 - $4,999,999	100.0	27.4	29.0	20.6	15.0	6.3	1.5
$5,000,000 - $9,999,999	100.0	23.2	27.1	22.0	16.9	8.6	2.1
$10,000,000 - $19,999,999	100.0	22.1	24.6	22.7	18.0	9.2	3.4
$20,000,000 - $49,999,999	100.0	22.0	19.9	20.6	19.7	12.0	5.7
$50,000,000 - $99,999,999	100.0	14.0	17.2	20.3	26.0	15.0	7.5
$100,000,000 or more	100.0	16.8	18.3	19.9	23.3	17.9	3.8

1/ LESS THAN 0.05 PERCENT



ANNUAL
REPORT
1977
of the
NATIONAL
CREDIT UNION
ADMINISTRATION

TABLE S-10.—NUMBER AND AMOUNT OF SAVINGS ACCOUNTS AND PERCENTAGE DISTRIBUTION IN FEDERALLY INSURED STATE CREDIT UNIONS, BY SIZE OF ACCOUNT AND SIZE OF CREDIT UNION, DECEMBER 31, 1977.

ASSET SIZE	TOTAL	SIZE OF SAVINGS ACCOUNTS					
		$1,000.00 OR LESS	$1,000.01 – $2,000.00	$2,000.01 – $5,000.00	$ 5,000.01 – $10,000.00	$10,000.01 – $20,000.00	$20,000.01 OR MORE
		NUMBER OF SAVINGS ACCOUNTS					
Total	8,995,124	6,762,927	772,269	902,441	334,688	160,876	61,923
Less than $10,000	992	984	8	------	------	------	------
$10,000-$24,999	4,972	4,882	71	18	1	------	------
$25,000-$49,999	16,183	15,499	470	195	18	1	------
$50,000-$99,999	38,232	34,822	2,037	1,217	132	21	3
$100,000-$249,999	177,232	153,153	12,503	9,831	1,473	240	32
$250,000-$499,999	294,676	241,314	24,109	23,631	4,390	1,067	165
$500,000-$999,999	475,461	375,758	41,344	45,164	9,723	2,934	538
$1,000,000-$1,999,999	769,826	597,469	67,557	77,286	19,502	6,521	1,411
$2,000,000-$4,999,999	1,366,326	1,031,531	123,464	145,568	44,046	17,293	4,424
$5,000,000-$9,999,999	1,397,533	1,045,551	121,729	147,347	52,133	23,255	7,518
$10,000,000-$19,999,999	1,336,004	1,017,394	103,501	135,471	48,684	23,132	7,822
$20,000,000 or more	3,117,687	2,244,570	275,476	316,713	154,506	86,412	40,010
		AMOUNT OF SAVINGS (IN THOUSANDS)					
Total	$11,756,617	$1,275,529	$1,128,902	$2,809,509	$2,376,673	$2,235,149	$1,930,854
Less than $10,000	69	58	10	1	------	------	------
$10,000-$24,999	663	498	96	56	10	2	------
$25,000-$49,999	3,292	1,947	661	520	139	25	1
$50,000-$99,999	13,131	5,505	2,849	3,463	891	343	81
$100,000-$249,999	85,553	26,435	17,853	27,500	9,505	3,236	1,024
$250,000-$499,999	187,919	43,519	33,407	64,984	28,096	13,287	4,626
$500,000-$999,999	374,190	73,338	57,533	127,310	64,614	37,177	14,217
$1,000,000-$1,999,999	701,366	113,449	99,130	229,305	133,296	86,471	39,707
$2,000,000-$4,999,999	1,475,016	204,883	178,850	434,079	301,500	230,527	125,175
$5,000,000-$9,999,999	1,677,024	196,311	171,563	434,820	352,500	304,849	216,981
$10,000,000-$19,999,999	1,724,897	189,194	159,557	444,935	359,574	330,682	240,956
$20,000,000 or more	5,513,497	420,390	407,385	1,042,537	1,126,548	1,228,549	1,288,087
		PERCENTAGE DISTRIBUTION OF NUMBER OF SAVINGS ACCOUNTS					
Total	100.0	75.2	8.6	10.0	3.7	1.8	.7
Less than $10,000	100.0	99.2	.8	----	----	----	----
$10,000-$24,999	100.0	98.2	1.4	.4	(1)	----	----
$25,000-$49,999	100.0	95.8	2.9	1.2	.1	(1)	----
$50,000-$99,999	100.0	91.1	5.3	3.2	.3	.1	(1)
$100,000-$249,999	100.0	86.4	7.1	5.5	.8	.1	(1)
$250,000-$499,999	100.0	81.9	8.2	8.0	1.5	.4	.1
$500,000-$999,999	100.0	79.0	8.7	9.5	2.0	.6	.1
$1,000,000-$1,999,999	100.0	77.6	8.8	10.0	2.5	.8	.2
$2,000,000-$4,999,999	100.0	75.5	9.0	10.7	3.2	1.3	.3
$5,000,000-$9,999,999	100.0	74.8	8.7	10.5	3.7	1.7	.5
$10,000,000-$19,999,999	100.0	76.2	7.7	10.1	3.6	1.7	.6
$20,000,000 or more	100.0	72.0	8.8	10.2	5.0	2.8	1.3
		PERCENTAGE DISTRIBUTION OF AMOUNT OF SAVINGS					
Total	100.0	10.8	9.6	23.9	20.2	19.0	16.4
Less than $10,000	100.0	84.1	14.5	1.4	----	----	----
$10,000-$24,999	100.0	75.1	14.5	8.4	1.5	.3	----
$25,000-$49,999	100.0	59.1	20.1	15.8	4.2	.8	(1)
$50,000-$99,999	100.0	41.9	21.7	26.4	6.8	2.6	.6
$100,000-$249,999	100.0	30.9	20.9	32.1	11.1	3.8	1.2
$250,000-$499,999	100.0	23.2	17.8	34.6	15.0	7.1	2.5
$500,000-$999,999	100.0	19.6	15.4	34.0	17.3	9.9	3.8
$1,000,000-$1,999,999	100.0	16.2	14.1	32.7	19.0	12.3	5.7
$2,000,000-$4,999,999	100.0	13.9	12.1	29.4	20.4	15.6	8.5
$5,000,000-$9,999,999	100.0	11.7	10.2	25.9	21.0	18.2	12.9
$10,000,000-$19,999,999	100.0	11.0	9.3	25.8	20.8	19.2	14.0
$20,000,000 or more	100.0	7.6	7.4	18.9	20.4	22.3	23.4

[1] Less than 0.05 percent.

Mr. WELSH. As far as the growth of credit unions, my written testimony indicates that the share of savings by credit unions, on page 13, in 1972, the share of all savings was 3.1 percent, and it is currently 4.3 percent. So even though we are talking about the big numbers in a single, big credit union, the total assets of all credit unions over $80 billion is the total assets of the whole 20,000. There is more than one bank that has more assets than that total combined credit union group that we are talking about. So even though there are one or two large ones, the tendency to focus on them and say that all of them have some differences I don't believe is accurate. The credit union structure and philosophy is still maintained regardless of that size, because the members demand it. They own that credit union.

Mr. HUTCHINSON. Mr. Chairman, if I might just offer one comment in regard to those two credit unions that you mentioned. To prove that the Democratic process is still working, those credit unions instituted a mail ballot procedure. When the officers of the credit union or the directors of the credit union are elected, each member has a right to vote and exercise that right. It is my understanding that they use that and they have had great success with it. It is just a point I wanted to bring forward to you.

The CHAIRMAN. Do I understand correctly or incorrectly, consumer co-ops can avoid income tax only if they distribute all their current income to their members? Do you think that puts you to some advantage, or do you still feel there is equality there? You don't have to distribute all of your income to avoid taxation, do you, because you are tax exempt, statutorily?

Mr. WELSH. Correct. Reserve requirements.

The CHAIRMAN. Do you think you should have an advantage over the consumer cooperatives?

Mr. WELSH. Well, we have reserve requirements. We were talking about tax advantages. that would have to be dealt with, because if there were an effective tax rate, as the study that came out in 1978, the proposal to tax credit unions in 1978, indicated there was no provision for that. And again in my testimony you would find that you can wind up not being able to fund the credit union reserves that are required by statute. And because 8,000 credit unions are state chartered, all those State laws would have to be adjusted also. And banking would have to address the bad debt reserve for the federally chartered credit union. So it creates a specific issue that becomes difficult to deal with just on that issue of bad debt reserve alone.

The CHAIRMAN. Has the credit unions estimated the cost of their campaign against withholding on interest and dividend income? [Laughter.]

I mean, how many hundreds of thousands of dollars have you spent on that campaign?

Mr. WELSH. I don't know what would have been spent in that campaign. I know that CUNA though, as an organization. I have a letter I would like to submit for the record to you, Senator, because we did not want to testify on withholding at this particular hearing because of the complexity of the withholding issue. But I do have it here indicating what CUNA has done.

[The letter follows:]

Credit Union National Association, Inc.,
Washington, D.C., March 10, 1983.

Hon. Robert Dole,
Chairman, Committee on Finance, U.S. Senate, Washington, D.C.

Dear Senator Dole: I wish to take this opportunity to explain the efforts made by the Credit Union National Association, Inc. (CUNA) to prepare the nation's 20,000 credit unions for compliance with the new laws on withholding on interest and dividends and withholding on individual retirement account distributions.

CUNA has attempted to provide its members with information on withholding. Despite our sincere belief that the law is unnecessary and premature, we are in the process of making a complete compliance package available to our members. On December 9, 1982, we held a compliance conference for our 52 credit union leagues and the data processors serving credit unions. At that conference, we made available a 153-page compliance manual. Since then, we have sold more than 6,000 copies of our compliance manual to credit unions throughout the United States ($10 per copy). Credit union leagues and chapters are holding hundreds of compliance seminars, using a 90-minute video-tape prepared by CUNA. CUNA staff is travelling throughout the United States visiting league meetings, and will conduct six national seminars during the month of April to educate our credit unions about the nuts and bolts of compliance.

CUNA has also provided extensive data on the cost of compliance to the Internal Revenue Service, Treasury, the Senate Finance Committee and the Joint Taxation Committee, in order to make a responsible argument that credit unions will be inadequately compensated for carrying this tax compliance program. We have recognized the need to be fair in presenting our cost esitmates and gladly met with representatives of the Internal Revenue Service on February 3, 1983, to explain in full the assumptions underlying the estimates that we have prepared. Obviously, at this stage it is very difficult to provide actual cost data—since no credit union has reported achieving full compliance. We would be pleased to provide our estimates for the record.

While CUNA remains extremely concerned about the cost of compliance and the impact of withholding on our members' savings, our association believes we have taken every step possible to prepare our members for withholding on interest, dividends and IRA distributions. We want to add that the staffs of the Internal Revenue Service and the Department of Treasury have been extremely helpful. We have greatly appreciated their availability to provide guidance and their responsiveness to our questions. We look forward to their continued assistance, as the withholding compliance date draws near, in resolving the technical and operational compliance problems that remain.

Sincerely,

Harold T. (Tom) Welsh, *First Vice-Chairman.*

The Chairman. Your information is not very complex.

Mr. Welsh. Right. As far as the complexity of withholding and the issues that have to be dealt with there. But this deals with what CUNA has done on the positive side on withholding. We have prepared a manual. We have sold over 6,000 copies of that manual for compliance. We have held conferences around the United States to teach credit unions how to comply if withholding does take place. Those manuals themselves were sold at $10, which is our cost for preparing the manual. We prepared a 90-minute videotape to help the credit unions. We prepared cost data on compliance. What it would cost credit unions. We submitted that to Treasury. And we have worked very closely with Treasury to resolve any differences or concerns that we have on how the implementation of that withholding will take place. So we have had that positive aspect on withholding going. It wasn't just the campaign to repeal.

The Chairman. I don't necessarily want to get into the withholding issue, but this is the Finance Committee and we are supposed to make certain the tax system is fair and that people pay their taxes, and that we don't raise your taxes if somebody else is not paying their taxes. And we are never going to have a perfect world with everybody paying their fair share and everybody participating in efforts to have economic recovery. But it seems to me when we are faced with $200 billion deficits, and a lot of pressure to cut spending in a lot of places, much of it from low income groups where the crunch is pretty difficult. I just don't really understand what is wrong with asking people who are not paying their taxes to do so. I don't understand the fundamental philosophy behind the credit unions and the S&L's and the banks in launching a massive campaign that is aimed not at a new tax, as some have advertised, but a compliance effort to make the system fair.

It may be repealed. I mean, there may be such a massive campaign that Members of Congress just can't stand the pressure. And I can see it taking its toll. So you may demonstrate to the American people that if the financial institutions have enough money and send in enough mail, Congress will cave in, despite whatever the issue may be. But I cannot believe that it's a matter of policy with the credit unions, or anyone else, that certain people should not have to pay their taxes or that you are not going to cooperate in tax compliance. That is for somebody else to do.

Mr. HUTCHINSON. Mr. Chairman, I don't think that anyone in the credit union world has any position other than this: Everyone should pay their fair share of taxes. I think the position we have taken is that the tax is being paid now.

The CHAIRMAN. Do you have some evidence on that? I mean, the IRS tells me that there is $20 billion a year in income not reported, interest and dividend income, which translates into $4 billion in lost taxes; that there are 20 million Americans—and I am not suggesting dishonesty—that don't report all of their interest on dividend income. And there is no way they can match it up with 1099's because of incorrect social security numbers and other defects when they are filled out.

Now we can all say it is being paid, but it is not being paid. And we have an obligation to see that it is paid. We can't sit here and preside over the Finance Committee and say, well, you don't have to pay your taxes. Just somebody else has to pay. It is Senator Long's old story you heard this morning, don't tax you, don't tax me, tax the fellow behind the tree. And I don't suggest that anyone likes taxes, but I suggest they would like them a little more if they felt everybody was going to pay their fair share. But do you have some evidence that all the tax is being paid on interest and dividend income? You may be paying all yours, but I am talking about nationwide.

Mr. HUTCHINSON. Well, of course, we can't speak for the other institutions; but we can say that we feel that our members are paying their taxes. There is one other point, Mr. Chairman, that I would like to make, and that is this: Even though the credit unions have not been taxed, we are the only Federal agency that I know of that is 100 percent supported by its own fees. There is no appropriation in the budget for the administration of credit union regulatory action. That is a good position I think and we are proud of that.

The CHAIRMAN. But you do get, what, low rent space in Federal buildings?

Mr. HUTCHINSON. There are provisions in the act to give Federal agencies free rent. That is correct.

The CHAIRMAN. But it would seem like with a billion dollars around, maybe at least we ought to look at some of those things. I don't think anybody is after anyone, but I don't understand. I mean these are big, big credit unions, several hundred million dollars. We just say, well, that is just a small little mom and pop operation, a little venture. Maybe that is the way it has been for 50 years or 30 years.

There are two Florida witnesses and we are told that they are holding the airplane for you at the airport. Are you going to try to catch another one?

Mr. GREENE. Hopefully, they will hold it for us.

The CHAIRMAN. Oh. It's not a commercial?

Mr. GREENE. No.

The CHAIRMAN. Oh. [Laughter.]

That sort of fits in with the hearing. What time are you leaving? I have got to go to Atlanta. [Laughter.]

Mr. GREENE. Hopefully, we will work it out. [Laughter.]

The CHAIRMAN. Well, all right. If they are going to hold it. We are about ready anyway. Well, I would just suggest that, you know, we are in the preliminary stages that I have indicated this morning. There are 6 million people who did not file returns a couple of years ago, and we are told that much of it is because they don't think the system is fair; that we take care of the rich and the ones with the big lobby, and the average taxpayer out there is forgotten. Now we may not be able to do much to change that. We did some last year, which you are trying to unravel now. And if we lose $4 billion a year, why we will just have to look somewhere else for it, or just add it to the deficit. And I am certain that that probably doesn't make any difference to you if we find it in some other place. But the President has said today he is going to veto the jobs bill if withholding is repealed. I haven't found anybody yet who has volunteered to pick up the $4 billion if the credit unions, and the S&L's and the banks are successful in their effort.

I get letters saying repeal withholding and get the economy moving again; collect taxes somewhere else. But we are going to do the best we can. And I appreciate very much your testimony. Mr. Roth, I appreciate your coming back. And we are doing a little better on the reporting side, but I don't think very much.

Mr. ROTH. I really think the IRS is doing the right kind of a job with their 1099 forms.

The CHAIRMAN. Well, I had Mr. Egger up here 2 weeks ago and I said if you can do it some other way, let's do it some other way. Now I don't know whether he is the last word or not, but the indication is that there is an 11-percent error rate for identification members and that adds up to billions of dollars.

Mr. ROTH. I never found one error in all the years on everything that was reported to me.

Mr. WELSH. Mr. Chairman, we certainly support adequate reporting. We support penalties for those who fail to report. We have always felt that way. And that fair share of tax has to be paid. The only problem we have with the withholding is that the cost totally goes right back to the credit union. It is not paid by the credit union; it is paid by the members. It is a reduction in the income. And we have provided those costs with the implementation of withholding to Treasury also. And it is significant for the smaller credit union. And there isn't any way that those costs can be recovered, even with holding the deposits and the mechanisms that are currently in place.

The **Chairman**. Well, we have been checking and there were some real concerns raised. I don't want to suggest that withholding is without its problems. And we have been telling the banks and the credit unions and S&L's if you have a problem, we ought to try to address it. But the problem is they don't want to do it. And I don't care how many times you address it, they still don't want to do it. And if they have got the muscle—and they probably have; they have got powerful PAC's and a lot of muscle around here—you would probably get it done.

Mr. **Roth**. Well, one of the first things that should be done is an improvement in the income tax form and also the 1099.

The **Chairman**. We are trying to improve the income tax law.

Mr. **Roth**. Well, we could push effort to see that they specifically point out items of interest and dividends.

The **Chairman**. Yes. But we are just told in the normal course. And again I haven't verified it. I haven't checked all the areas, but we are told that just in the normal course of handling millions and millions of pieces of paper, 400 million 1099's, what do you do with 400 million 1099's? You do the same thing with all that mail they got. You pile it up and hope that someday you can look at it. Well, thank you very much.

Mr. **Welsh**. Thank you, Mr. Chairman.

The **Chairman**. Now we get the jet set up here. Mr. Roy G. Green, president, Federal Savings & Loan Association, Jacksonville, Fla., on behalf of the U.S. League of Savings Institutions, Washington, D.C.; Raleigh W. Greene, president, Florida Federal Savings & Loan, St. Petersburg, Fla., on behalf of National Savings & Loans League, Washington, D.C.; Harry Pryde, president of the National Association of Home Builders, Washington, D.C.; and Herbert W. Gray, chairman of the National Association of Mutual Savings Banks. And I might say to the last panel that there will be some questions submitted by staff that we hope you might respond to.

STATEMENT OF ROY G. GREEN, PRESIDENT, FIRST FEDERAL SAVINGS & LOAN ASSOCIATION, JACKSONVILLE, FLA., ON BEHALF OF THE U.S. LEAGUE OF SAVINGS INSTITUTIONS, WASHINGTON, D.C.

Mr. **Green**. Thank you, Mr. Chairman. My name is Roy Green. I am president of First Federal Savings of Jacksonville, Fla., and appear today on behalf of the U.S. League of Savings Institutions. We welcome this examination of the tax laws affecting the savings and loan associations and mutual savings banks which comprise our membership.

Under the formula established by the 1969 Tax Reform Act, savings and loan associations—in years when they have positive income—pay substantial taxes. Our effective tax rate was 26.5 percent in 1979 and 27.9 percent in 1980, our last profitable years. As I am sure this committee is well aware, for most of the past 3 years our institutions, with very few exceptions, have operated in the red. Industrywide, our net worth-to-assets ratio has dropped from over 5 percent to a little over 3 percent in 2 years time. Operating losses during a period of punishingly high interest rates have used up roughly $10 billion in accumulated net worth. Hundreds of companies had to be merged out of existence.

During this period of time, our section 593 bad debt reserve has provided a valuable cushion against even greater deterioration. Though originally conceived to encourage home finance and to protect against credit risk, the section 593 reserve has been most useful in coping with the interest rate risk inherent in our traditional borrow-short, lend-long operations.

Last year's Garn-St Germain Act developed by the Senate Banking Committee, and the evolution and mortgage instruments, should eventually help us return to financial health and to positive tax-paying status—if we can avoid an early return to high interest rates. The tremendously popular money market deposit account is transforming our liabilities to short-duration market-rate deposits, and the transformation is occurring much more rapidly than is possible on the asset side of our balance sheet—even with the flexibility provided with the Garn-St Germain law.

Thus, the timing of any basic tax law changes is important. A new tax burden now could disrupt our chances for recovery. As I have pointed out, in profitable years the section 593 percentage of income tax treatment for thrift institutions still produces a significant effective tax rate and sizeable revenues for the Treasury.

We, as an industry, remain committed to home finance. Since Garn-St Germain was enacted, we expanded real estate residential mortgages by a near-record $8 billion in December 1982 and $6 billion in January 1983. Demographic trends clearly point out that there is a major public need for our continued participation in home finance in the decade of the 1980's.

There are improvements which need to be made in section 593. For one thing, Garn-St Germain made federally chartered S&L's and savings banks virtually indistinguishable, yet the tax laws contain different eligibility standards: 82 percent in qualifying loans for S&L's and 72 percent for mutual savings banks. As a follow-through to the Banking Committee's restructuring, both should be at the 72-percent level and consideration should be given to modernizing the qualifying list to include real estate loans on commercial property.

In our view, it is inappropriate to retain our section 593 treatment on the list of preference items subject to the minimum corporate tax. Our bad debt reserves, as I said before, cover real losses. Other tax law oddities handicap our institutions in the full use of the investment and targetted jobs credits. And my full statement explains some of the other "housekeeping" which would simplify the code treatment of home finance institutions.

In addition, we ask for parity with other corporations in loss carry-forward treatment.

Finally, I wish to express our support for the retention of the one-percent-of-eligible loans reserves used primarily by commercial banks.

The U.S. League certainly welcomes this opportunity to review the Tax Code provision which apply to thrift institutions, and I will be pleased to respond to any further questions by the chairman. Thank you, sir.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Roy G. Green follows:]

STATEMENT OF ROY G. GREEN
ON BEHALF OF THE U.S. LEAGUE OF SAVINGS INSTITUTIONS
TO THE SENATE COMMITTEE ON FINANCE

March 11, 1983

MR. CHAIRMAN:

My name is Roy G. Green. I am President and Chief Operating Officer of First Federal Savings of Jacksonville, Florida. I appear today on behalf of the United States League of Savings Institutions, of which I am Immediate Past Chairman. The League represents 3,700 savings and loan institutions nationwide, and includes many prominent savings banks as associate members.

The U.S. League is pleased to present its views on the important topic of financial institution taxation. In common with all honest taxpayers our member institutions are concerned that tax burdens may not be shared equitably. We welcome periodic Congressional examination of the fairness of the undeniably complex Internal Revenue Code and its implementation by the IRS.

Equity Considerations:

Though public attention focuses on the individual income tax, the corporate income tax remains a substantial revenue source. By its very nature corporate economic activity involves greater complexity in tax treatment. Correspondingly, it is a difficult task to assure that competitors are treated equally.

Concern for horizontal and vertical equity in corporate taxation will remain as long as the corporation is treated as a taxable entity distinct from its shareholders. Integration of the corporate and individual tax systems remains theoretically attractive though practically difficult: the progress made in that respect in Western Europe is worth studying. Integration may well be the fairest solution from the economist's perspective; that was how the U.S. Tax Code was structured in the first eight years of federal income taxation (from 1913 to 1921).

Until such integration is achieved, comparisons between individual corporations and among competing industries remain vital in the determination of relative tax burdens. For our savings institution business, as a participant in the financial institution sector, the key comparison must be with our major competitor, the commercial banking industry.

Effective Tax Rates of Banks, Savings Institutions and Others:

Exhibit 1 shows the progression of effective tax rates for thrift institutions and commercial banks since federal corporate taxation was applied to "domestic building and loan associations" in 1962. (Prior to that time, savings and loan associations were largely tax-exempt, reflecting their origins as mutual organizations, owned by their depositors, much like present day credit unions.) After the Revenue Act of 1962, the burden remained relatively steady until the Tax Reform Act of 1969. From 1969 to 1979 the tax burden on savings institutions rose steadily as a ten-year phase-in of the key thrift tax provisions was accomplished.

By contrast, the effective tax rate at commercial banks declined steadily from the early 1960s through the late 1970s. Since 1971 the tax burden on savings institutions has been higher than that on commercial banks.

Exhibit 1 closes with the figures for 1980. That year was the last full year when both savings institutions and commercial banks were strongly profitable, enabling valid comparisons undisturbed by other corporate tax code provisions. The progressivity of the corporate tax under $100,000 of income, timing differences between financial and taxable income, etc., distort meaningful comparision after 1980. Thrift earnings were substantially negative in the last two years -- making comparisons to positive commercial bank taxes temporarily meaningless.

It is important to emphasize that the comparisons in Exhibit 1 are based on financial rather than taxable income. Tax code provisions may produce a substantial divergence between income for tax purposes and true income.

The reason that banks bear a relatively light burden is, first, that a large portion of their income is derived from exempt sources (and thus excluded from federal taxation) and, second, because of greater use of foreign and investment tax credits. Tax stratagems available to banks derive from their flexible investment asset powers. Those activities are fully in accordance with tax law and regulation.

We would simply point out that the net result of these provisions of the Tax Code is to impose a substantially larger burden on savings institutions.

The exact extent of this excess burden relative to banks is subject to some slight variation depending on the nature of the adjustments made to taxable and financial income to obtain a figure for true, economic income as the measure of tax paying ability. These variations are, however, minor compared to the gap between tax burdens. Even analysts not basically sympathetic to the structure and operations of thrift institutions agree that their tax burden is higher than that which affects commercial banks.

Since the thrust of these hearings is to ensure that financial institutions in general are paying their fair share of the tax burden, it is also appropriate to point out here that the savings institutions' effective tax rate in 1979 of 26.5% was quite close to the 28.1% rate paid by the construction industry, and the 27.8% of wholesale and retail trade. Clearly, when operating profitably, our institutions are well within the normal variation for other corporate enterprises.

Impact of High Interest Rates on Earnings:

Beginning in 1979, the entire corporate sector was hit by a prolonged decline in economic activity and earnings. The housing and finance sector has been particularly hard hit by the upward spiral of market interest rates and resulting recession. As the Committee is no doubt aware, the costs of attracting and holding deposits far exceeded the return on our investment portfolios filled with low-yielding mortgages made years ago. The operating "spreads" were decidely negative in the latter part of 1980, 1981 and most of 1982.

Though final results for calendar year 1982 are not available, it seems clear that losses last year slightly exceeded the $4.6 billion loss of 1981 producing a two year total of approximately $10 billion. Almost every institution suffered losses over the period and a significant number found their net worth positions so depleted that merger solutions became necessary. Federal Savings and Loan Insurance Corporation-assisted mergers rose to unprecedented levels involving projected insurance fund outlays of over $2 billion over the coming years. A far higher number of supervisory unassisted and voluntary mergers reduced the total number of savings associations by 779 from January 1981 through November 1982. That is over 20% of the institutions in the industry.

Fortunately with the recent declines in interest rates and some strengthening of economic activity and housing markets, the worst of our earnings "squeeze" appears to be over, at least for the time being. In November 1982, the savings association business reported its first positive monthly earnings in two years. A large part of that positive bottom line represented non-recurring extraordinary income but, even so, the negative operating spread is narrowing quite rapidly.

There is a reasonable prospect of breakeven operations by mid-year 1983 and possibly profitable operating results in the second half of this year, provided that interest rates do not turn upwards again. Overall, however, despite that improvement, there is little chance that corporate tax collections from savings associations will represent a significant revenue source for the Treasury in 1983. We sincerely hope that 1984 will approach a "normal" year like 1979.

Savings Institution Loss Reserve Methods:

The size of the losses suffered in the current earnings squeeze is ample testimony to the need of the savings institution business for the only significant tax provision specifically tailored for savings institutions. That provision is the special Section 593 bad debt treatment available to qualifying institutions.

The phase-down of that percentage-of-taxable-income bad debt provision from 60% to 40% -- as mandated by the 1969 Tax Reform Act -- is the basic reason for the rising tax burden of our institutions over the 1970s. A brief outline of the workings of that provision may be helpful.

To use this special provision an institution must pass three tests: a "supervisory" test, a "business operations" test, and an asset structure test. The third test is the only binding constraint: savings institutions automatically pass the first test by their very definition as supervised domestic building and loan associations; the business operations test merely requires that 75% of gross income be derived from income from (all types) of loans. Since, operationally, thrift institutions remain "loaned up" none ever come close to breaching that requirement.

The third test requires that a savings and loan (or stock savings bank) institution have 82% of its investments (72% for "mutual" savings banks) in specified qualifying assets to claim the full percentage-of-taxable-income bad debt deduction.

For each 1% that the asset structure falls below that 82% (72%) level, the allowable bad debt percentage deduction drops .75% (1.5% for mutual savings banks) until the deduction disappears if qualifying assets fall below a 60% level. The Tax Reform Act of 1969 did not alter the qualifying asset structure. It simply reduced in stages the 60% available as a deduction prior to 1970 to the 40% available since 1979 as a permanent statutory deduction.

The bad debt deduction was designed to build up special reserves solely to cover unforeseen losses and not for distribution to shareholders. As its name implies, the type of loss that was originally contemplated was credit loss rather than loss from interest rate risk.

When deposit deregulation for supervised depositories began with the introduction of the six-month money market certificate in 1978, and rapidly rising rates promoted the competition from the explosive growth of unregulated money market mutual funds, the risk structure of savings institutions changed dramatically.

The availability of the tax code's loss reserves -- though diminishing in size under the formula of the 1969 Act -- provided a valuable cushion which enabled more institutions to weather the financial storms of the past three years than would have done so otherwise.

Conforming Revisions of Tax Law to New Powers:

The financial results of the recent past show conclusively that such contingency reserves are absolutely essential and that there is no justification for any further reduction in the thrift loss reserve provision. Savings institutions, as shown above, certainly do pay their fair share of taxes when they are operating profitably.

That is not to say there is no need or for some revision and simplification of the bad debt reserve section of the tax code.

The most pressing need is for some conforming tax law changes to recognize the revised list of savings institution asset authorities incorporated in the comprehensive Garn-St Germain Depository Institutions Act of 1982 (Public Law 97-320).

Congress wisely realized that our institutions could not return to financial health -- and positive taxpaying status -- without substantial overhaul of our authorities on both sides of our balance sheet. The percentage-of-asset limitations within which our institutions must operate were radically altered and a major new category added. For the first time, our institutions may make non-real estate commercial loans (though only up to 10% of total assets). Under that law investments in commercial real estate are permitted to 40% of assets and the consumer loan asset "basket" goes from 20% to 30%.

On the liabilities side the spectacular reception by the public for the new Money Market Deposit Account (introduced, pursuant to the Garn-St Germain Act, on December 15, 1982) and

Over the longer term, these new powers will enable savings institutions to restructure themselves so that they may withstand the vicissitudes of interest rate movements -- particularly rapid escalations as experienced through much of 1979-1982. In the near term, however, an added degree of interest rate risk has been imposed on the business from a much quicker transformation of the liabilities than is possible with the assets side of the balance sheet. Savings institutions already have $100 billion in the new Money Market Deposit Accounts; any switch to similarly flexible-rate assets will take far longer.

Another fundamental change found in the Garn-St Germain Act makes federally-chartered savings and loan associations and savings banks virtually indistinguishable in their powers and authorities; furthermore, these thrift institutions may switch freely between one charter form or the other.

While that asset rebalancing proceeds, as long as interest rates remain well behaved, it is vital that loss reserves be built up to cover upward rate spikes. Interest rate gyrations could have an even more severe impact over the next few years until that asset rebalancing has produced some results. Added interest rate and credit risk requires added tax flexibility in providing for these contingencies.

Thus, the U.S. League recommends that the disparity in the percentage-of-asset tests between mutual savings banks (72% to qualify) and savings associations (and stock savings banks, 82%) be immediately eliminated. As mentioned, the new financial institution legislation opens the way for a straightforward charter switch from federal savings and loan association to federal savings bank status. A revision in the asset test for federal taxation to a uniform 72% level would simply recognize that change in financial legislation. (No change is necessary in the 60% "floor" for qualifying assets to utilize the percentage of taxable income method; if the 82% test were altered to 72% for each of these comparable institutions, a savings and loan or stock savings bank would thus surrender 1.5% of its deduction eligibility for each 1% shortfall in qualifying assets.)

It is also appropriate to make some conforming revisions in the list of qualifying assets which has not been examined for 20 years. We would recommend that that, at a minimum, real estate loans on commercial properties be added to the "qualifying assets" list.

It may be appropriate at this point to address the allegation that savings institutions are preparing to desert housing finance. The facts certainly refute those allegations. Since Garn-St Germain was enacted, savings institutions expanded their residential mortgage loans by a near-record $8 billion in December and almost $6 billion in January. The recent rapid increase in mortgage lending activity clearly shows the strength of underlying demand for housing credit. Demographic trends point to a major increase in housing requirements in the coming decade. Mortgage credit needs will continue to expand rapidly.

In addition, there will be some evolution in the mortgage instrument over time as the valuable flexibility given by Federal Home Loan Bank Board regulation and tie-in provisions of the Garn-St Germain bill are put to use. (It would clearly be imprudent for a portfolio lender to make exclusively 30-year fixed rate loans funded by the day-in, day-out money provided by the new money market accounts.) Our institutions want to continue to be heavily involved in real estate financing, their area of greatest expertise. Innovative mortgage instruments will evolve to meet the needs of both borrower and lender as market forces respond to the changing environment.

Even from the narrower, tax collection perspective, it makes little sense to continue to mandate solely those lines of business which are guaranteed to push the institution under water at the next significant upturn in interest rates.

Loss Reserves and the Minimum Tax:

The events of the last two years also show that the classification of the thrift loss reserve as a "preference" item subject to the Minimum Tax (Section 56) is inappropriate. Those reserves have been used to cover real losses. Managers of institutions which have been merged out of existence could point to the impact of the 1969 Tax Reform Act on their operations and argue that the higher reserves which would have been permitted prior to that act might have kept them in business.

The determination that these loss reserves should be included as a preference item was made when perceptions were far different from today. Recent experience and the changed structure of the financial sector have made contingencies which can exhaust these reserves all too likely. We strongly urge that the provision of the 1969 Act which classes these reserves as preference items be eliminated.

Though of no significant impact to date, we would note that under last year's Tax Equity and Fiscal Reponsibility Act, the excess of the bad debt deduction claimed over the amount of that deduction computed on the experience method is included in the base of the 15% corporate surtax.

Loss Reserve Methods and Housekeeping Corrections:

We note that there is some disposition to intervene in the workings of the 1969 Tax Reform Act. That act, besides the already completed phase-down of the thrift loss reserve, also incorporated a phase-out of the percentage of eligible loans bad debt method. This is known in the trade as the "commercial bank" bad debt method, since it is the customary method utilized by commercial banks (though it is also available to other depositories). The 1969 act scheduled the commercial bank percentage to phase down from an original 1.8% of eligible loans deduction to 1.2% in 1976, to 0.6% in 1981 and finally down to zero in 1987.

Last year the scheduled decline from 1.2% to 0.6% was replaced by a 1.2% to 1.0% drop. Now there are efforts to maintain that 1.0% level as a permanent option available to depository institutions. The U.S. League supports that initiative.

Our institutions have the choice of three loss reserve methods: the thrift percentage-of-taxable income method; the commercial bank percentage-of-eligible loans method; and the experience method available to all taxpayers. If there is a perceived disparity in thrift use of the commercial bank method when banks cannot use the thrift method, the tax writing committees of Congress may wish to consider the possibility of allowing those commercial banks which meet the asset structure definition for the thrift method to use that alternative.

Like other taxpayers and many in the Congress, we have supported efforts to simplify the Internal Revenue Code.

In that regard, we would recommend some "housekeeping" corrections of the technicalities of the thrift method. The "business operations" test as mentioned above, is virtually meaningless. No thrift institution to our knowledge fails, or has come close to failing that test. A statutory requirement that the function of a domestic savings and loan association is to take deposits and make loans would suffice. The calculations for this 75% test are mere surplusage cluttering up the Code.

As also mentioned, the supervisory test may also be reviewed to permit those few commercial banks which are structured like savings institutions to use the thrifts' percentage-of-taxable income loss reserve method.

The calculations for the loss reserve are also made more complex by two redundant limitations on the allowable deduction. First, the deduction is permitted only to the extent that the reserve for losses on qualifying real property loans does not exceed 6% of the total qualifying real property loans outstanding at the end of the tax year. This involves some very complex calculations. Second, the deduction cannot exceed the excess of 12% of the total of deposits at the end of the taxable year over the total combined tax loss revenues, surplus and undivided profits at the beginning of the tax year.

Since the net worth and reserve position of our business has been significantly eroded over the recent past, these complex "6% of qualifying loans" and "12% of year-end deposits" provisions are unnecessary. They could be removed from the computation process with no effect whatsoever on corporate tax revenues for the foreseeable future.

Net Operating Loss Carryover Rules:

The negative earnings experience of the past two years has produced significant operating loss carryovers for savings institutions. The pervasive influence of the bad debt deduction on tax issues for our institutions is seen here also. A 1979 IRS ruling required the recomputation of any percentage-of-taxable income loss reserve deduction for any year to which a net operating loss is carried back. The effect of this ruling has been to reduce significantly the per-dollar tax recapture of a net operating loss carryback by a thrift institution.

Even so, a large number of institutions have lost a sufficiently large amount in 1981 and 1982 that the federal taxes paid in the entire 10-year carryback period have been recaptured, leaving significant tax carryforwards. The 1981 Economic Recovery Tax Act expanded carryforwards to 15 years for corporations generally (giving these taxpayers a combined 18 year carryback / carryforward period), However, our institutions continue to have only a 15 year combined carryover period, 10 back and 5 forward.

Since the 1979 IRS ruling substantially limited the benefits of tax carrybacks precisely before those provisions were triggered by the poor earnings of 1980, 1981 and 1982, we recommend that financial institutions be given the extended 15 year carryforward available to other corporate taxpayers. At a minimum the carryforward should be made at least 8 years to achieve parity with the above 18-year combined carryover period of other corporations.

Tax Credit Revisions:

The thrift loss reserve provision is also the reason that savings institutions are given only half the investment tax credit available to other taxpayers -- including our commercial bank competitors. This anachronism was built into the Code when the original investment credit was conceived in the Kennedy Administration, at a time when thrifts had minimal federal corporate tax liabilities. However, as explained above, today thrifts pay higher effective tax rates than commercial banks and many other corporate taxpayers.

The 50% restriction on our use of the investment credit is particularly unfair in the financial marketplace. To use a simple example, a commercial bank installing an automated teller machine or a new vault gets full use of the credit while its thrift competitor across the street is limited to half the tax credit.

Similarly, savings institutions can claim only half the jobs credits available to other corporations. Employment incentives anywhere in the economy should not be unnecessarily reduced, especially in industries such as ours which employ large numbers of entry-level, semi-skilled personnel.

Other Technical Issues:

Corporate charitable contributions and dividends received deductions by thrift institutions are also reduced. In each case adverse, discriminatory tax consequences are justified by an unsupportable assertion that the loss reserve enables savings institutions to escape their fair share of taxes. That is not true: these provisions should be eliminated.

There is a further oversight in the tax law related to the bad debt deduction and financial restructuring legislation. That is the tax treatment of redemptions of mutual capital certificates. These securities, essentially redeemable preferred stock, were authorized by the 1980 Deregulation and Monetary Control Act. Potentially, they could play a significant role in the recapitalization and restructuring of mutual thrift institutions if the adverse tax consequences of their issue and redemption are addressed. Currently, under Section 593(e) it could be argued by the IRS that when these instruments are redeemed, a taxable event has occurred involving a distribution from tax reserves and consequently a tax liability is triggered. Though the IRS has not ruled on this issue, statutory clarification would be helpful and would avoid any prolonged shadow over the marketability of these instruments.

The 1981 tax act did remove any question as regards potential tax consequences of redemptions of the "income capital certificates" and "net worth certificates" issued by the FSLIC under its capital assistance programs (as subsequently established in Title II of the Garn-St Germain Act). That provision should be extended to the recapitalization efforts from within the private sector. It is in everyone's interest to minimize the exposure of the Federal Savings and Loan Insurance Corporation to losses through institutional failures and replace public with private resources wherever possible.

The 1981 Tax law also introduced the general rule that FSLIC assistance was not to be included as taxable income to the recipient. That provision has been extremely helpful to the FSLIC in its negotiation procedures in dealing with potential rescuers of problem institutions from both inside and outside the savings institution business. Any limitation of that provision, as has been suggested by some, would increase the costs of resolving any problem case. In light of the Congressional affirmation (H. Con. Res. 290, 97th Congress) of the Federal Government's unconditional commitment to the safety of institutions, in federally-insured institutions, changes in this regard would merely alter the bookkeeping classification in the federal budget for financial assistance. With fewer tax benefits, potential supervisory merger partners will simply negotiate more assistance from the FSLIC before agreeing to take over a problem case.

Any proposals in this area should bear in mind that recent changes in the accounting treatment of financial institution mergers under Generally Accepted Accounting Principles have already increased the adverse financial reporting consequences of problem case acquisition. FSLIC assistance must now be booked as a reduction in goodwill arising from the merger rather than as income; a reduction in tax benefits will further increase assistance costs.

Any changes in tax treatment, or imposition of a sunset provision on this tax free status, will add to FSLIC costs and should be viewed in that light. Since we do feel strongly on the equity question in tax issues, however, we would not object to measures which would place FDIC assistance on an equal footing with FSLIC assistance.

# # #

Mr. Chairman, this concludes the testimony of the U.S. League on financial institution taxation. Again, let me express our appreciation for your leadership in convening these important hearings. I look forward to your questions.

Exhibit 1

EFFECTIVE TAX RATES OF COMMERCIAL BANKS AND SAVINGS AND LOAN ASSOCIATIONS, 1960 - 1981

(Dollars in Thousands)

	Insured Commercial Banks			Insured Savings Associations		
	Net Income Before Federal Taxes	Federal Income Taxes	Effective Tax Rate	Net Income After Interest, Before Federal Taxes	Federal Income Taxes	Effective Tax Rate
1960	$ 3,301,648	$ 1,300,940	39.4%	$ 551,696	$ 3,755	0.7%
1961	3,311,189	1,317,292	39.8	715,660	3,485	0.5
1962	3,161,758	1,159,725	36.7	820,426	3,080	0.4
1963	3,280,057	1,130,629	34.5	764,559	93,054	12.2
1964	3,308,504	1,050,624	31.8	918,883	131,299	14.3
1965	3,385,993	927,423	27.4	929,812	133,626	14.4
1966	3,528,586	911,585	25.8	727,441	96,788	13.3
1967	4,079,182	1,020,988	25.0	711,076	93,784	13.2
1968	4,412,383	1,086,889	24.6	1,011,120	148,503	14.7
1969	5,996,674	1,287,514	21.5	1,230,390	194,491	15.8
1970	6,616,944	1,619,790	24.5	1,141,235	216,152	18.9
1971	6,769,726	1,367,492	20.2	1,673,473	359,847	21.5
1972	7,127,007	1,288,725	18.1	2,204,617	517,190	23.5
1973	8,280,408	1,336,317	16.1	2,518,224	621,280	24.7
1974	8,702,279	1,357,394	15.6	2,014,666	532,076	26.4
1975	8,554,333	1,225,927	14.3	1,948,732	500,335	25.7
1976	9,212,321	1,371,638	14.9	3,025,010	775,238	25.6
1977	10,649,360	1,773,219	16.7	4,349,524	1,151,342	26.5
1978	13,293,781	2,537,962	19.1	5,403,863	1,485,747	27.5
1979	15,483,746	2,653,009	17.1	4,927,173	1,307,227	26.5
1980	16,467,000	2,466,000	15.0	1,078,590	294,618	27.3
1981	18,413,000	1,689,000	9.2	-6,122,721	N/A	N/A

SOURCES: Federal Deposit Insurance Corporation; Federal Home Loan Bank Board

STATEMENT OF RALEIGH W. GREENE III, PRESIDENT, FLORIDA FEDERAL SAVINGS & LOAN, ST. PETERSBURG, FLA., ON BEHALF OF THE NATIONAL SAVINGS & LOAN LEAGUE, WASHINGTON, D.C.

Mr. GREENE. My name is Raleigh Greene. I am the president of Florida Federal Savings & Loan headquartered in St. Petersburg, Fla. I am appearing here today representing the National Savings & Loan League. I appreciate the opportunity to share with you the National League's thoughts and views on taxation. The National League believes that the bad debt allowance should be modernized to reflect the changing economic and competitive environment of the industry. Basically, we suggest that the 82-percent asset test in the BDA be reduced to 60 percent to allow us to accomodate new investment authority granted by this body in the Garn-St Germain Act. We believe this action will give savings and loans the ability to strengthen their asset base and allow them to continue to be viable mortgage lenders in the future.

In addition, we outline a number of other provisions of the code which we believe unnecessarily penalize savings and loans in relation to other commercial entities. These are listed in our full statement. I would like to take this opportunity to point out, however, that the 15-year carry forward is of special importance to the thrift industry.

Because the Congress viewed the BDA as a special tax preference, significant negative tax treatment has been placed upon the savings and loan industry in other areas. One, savings and loans only receive 50 percent of the investment tax credit; two, operating loss carrybacks are reduced by the amount of applicable BDA; three, special limitations on consolidated returns limit the value of BDA to S&L's with operating subsidiaries; four, savings and loans have paid in years where the industry maintained a profit a substantial effective tax rate. Those are simple facts.

While, I have only had a very short opportunity to briefly review it, I would like to share with you a few comments on the March 9 Joint Taxation Committee study of taxation of banks and thrift institutions. The comments only apply to the section of the study relating to savings and loans. On the whole, it appears to be fairly well balanced. Hopefully, you, as chairman, and the members of the committee will give full consideration to the positive aspects of current tax preference provisions outlined in the study. If you are contemplating changes, hopefully you will give long, hard thought to the impact of these changes on the thrift industry's ability to continue to build reserves and to invest in housing.

There are really two policy questions that need addressing. First, what constitutes adequate reserves for financial institutions, and given considerations of proper and existing reserves, what should the tax policy relating to additions to these reserves be? Second, what is the appropriate treatment of income arising from residential mortgages given the social and economic objectives related to housing?

In closing, the testimony presented today, we repectfully submit, is consistent with the Congress stated desire to encourage residential housing for our citizens. Deregulation is upon us. And I have confidence that this committee is sensitive to the fact that for housing to be provided, the thrift industry must be given adequate time to restructure its present asset/liability gap problem to continue to serve our country's housing needs. Further, in enactment of the Garn-St Germain Act the Congress recognized that for housing to remain a major national priority, consideration must be given to the thrift industry to allow us sufficient time and ability to continue serving our country and your constituents. Thank you for your attention. I will be glad to respond to any questions.

The **CHAIRMAN**. All right. I just wonder if it is all right with the other members of the panel, since you do have a travel problem——

Mr. **GREENE**. No sir, there is no problem.

The **CHAIRMAN**. Are you sure?

Mr. **GREENE**. Yes, sir.

The **CHAIRMAN**. All right. I don't want to keep you here.

[The prepared statement of Mr. Raleigh W. Greene III, follows:]

TESTIMONY OF RALEIGH W. GREENE III

Mr. Chairman, members of the Committee, my name is Raleigh W. Greene III. I am President of Florida Federal Savings and Loan Association, St. Petersburg, Florida. I am Vice Chairman of Governmental Affairs for the National Savings and Loan League, on whose behalf I appear here today.

I am pleased to have the opportunity to participate in these hearings to review the taxation of regulated financial intermediaries.

HISTORY OF S&L TAXATION

Savings and loan associations were exempt from taxation prior to the Revenue Act of 1951, when the Treasury Department proposed eliminating the tax-exempt status of thrifts. The Revenue Act of 1951 brought savings and loans into the tax code as recognized profit-oriented corporations and created special provisions relating to loss reserve accumlations, which limited these to net income or 12 percent of deposits. While these actions effectively ended the concept of savings and loans as tax-exempt entities, in practical effect the provisions resulted in almost no tax payments for the industry.

In 1961, the Treasury Department prepared a study on taxation of thrift institutions which resulted in recommendations for changes in the taxation of both savings and loans and mutual savings banks. The Revenue Act of 1962 resulted in extensive changes in the tax structure for savings and loans by drastically altering what constituted bad debt reserves for tax purposes. The law created a bad debt allowance (DBA) of 60 percent of taxable income or the amount necessary to bring the balance of reserves on qualified real property up to 3 percent of such loans. In addition, the 1962 law retained the 12 percent-of-deposits restriction on loss reserves accumulation from the 1951 Act.

In addition, the 1962 Act placed two restrictions on the 60 percent-taxable-income-method option for calculating loss reserves. First, under the 60 percent method, the amount added to these reserves could not increase total reserves to more than 6 percent of qualified property loans. Second, a specific definition of a building and loan which contained asset test limitations was written into law; the law also restricted full use of the BDA to those savings and loans that had specified percentages of assets (cash, U.S. government obligations and certain real estate loans).

The changes in the 1962 law resulted in a large increase in the amount of federal taxes paid by savings and loans. The effective tax rate of savings and loans grew from approximately 1 percent to around 15–16 percent of economic income as a result of this law.

In the 1969 Tax Reform Act, further restrictions on the use of the bad debt allowance were adopted. Under the Act, the percentage-of-taxable-income method was phased from 60 to 40 percent over ten years, and to qualify for the full BDA, savings and loans had to maintain 82 percent of their assets in specified qualifying assets. Failure to meet the 82 percent assets test resulted in reduction of the BDA.

Finally, the 1969 Act created a new 10 percent minimum tax on corporations and specified the bad debt allowance as a preference item to be included when figuring the minimum tax.

The 1969 Act increased the tax rate of savings and loans to around 27-30 percent by 1979.

These provisions provide the basic method of taxation of savings and loans today. The bad debt allowance remains the same as written in 1969. Changes have been made in the minimum tax provisions which have reduced the impact of the BDA—the latest being in 1982 when the Tax Equity and Fiscal Responsibility Act reduced certain tax preferences, including the BDA, by 15 percent. These changes and number of others made in the Tax Equity and Fiscal Responsibility Act will bring the effective rate of savings and loans to an even higher rate in the future.

Because the Congress has viewed the bad debt allowance as a special tax preferene item, it has over the years restricted the use of a number of other tax provisions by savings and loans. For example, savings and loans receive only 50 percent of the investment tax credit allowed other busineses. Today, thrift institutions are the only business with such a restriction. Further the amount of operating loss-carrybacks has been reduced by the amount of the bad debt allowance, and special limitations on consolidated returns have been devised which limit the value of the BDA to savings and loans that are part of a group filing a consolidated return.

Given this scenario of "the right hand giveth and the left hand taketh away" and the traditional limited investment authority of savings and loan institutions, savings and loans have paid taxes at a substantially higher rate over the years that other regulated financial intermediaries.

WHY THE BAD DEBT ALLOWANCE?

The bad debt allowance was created by the Congress to achieve certain public policy goals. First, thrift institutions (particularly savings and loans) were given the bad debt allowance because of the characteristics of their investment authority which was, by statute, largely confined to long-term mortgages and to encourage investment in residential mortgages.

Secondly, the bad debt allowance provided, through the tax preference mechanism, recognition of the need for regulated thrift institutions to build reserves to cushion against losses.

These public policy goals are still valid today.

The bad debt allowance assumes particular importance today because of the adverse economic circumstances faced by the savings and loan industry in the past two years. The high interest rate cycle experienced since 1979 has adversely affected savings and loans. First, they have been required by the marketplace and by deregulation of liabilities to pay higher and higher rates of interest to obtain deposits. Secondly, savings and loans' limited investment authority and fixed-rate, long-term asset structure restricted their ability to increase their asset yield. These factors have caused the highest level of losses in the history of the industry and have resulted in reduced reserves for the industry as a whole. While these losses are directly the result of bad debt through foreclosures, but losses created by a negative spread, they nonetheless depleted reserves. It is imperative that the industry use the current, more favorable economic environment and the recent increased investment authority to restructure and to build reserves in order to sustain future adverse economic cycles and to maintain public confidence. The bad debt allowance provides one of the tools to do this.

If, however, savings and loans are to effectively meet these goals, the National League recommends that the bad debt allowance be modified in the following manner:

(1) Reduce the percentage of assets test from 82 to 60 percent. Or expand the definition of qualified assets which are used to define eligibility for the BDA to include commercial real estate loans.

(2) Remove the bad debt allowance as a tax preference item for purposes of computing minimum tax.

These changes would allow the savings and loan industry to modify its asset structure as authorized in the Garn-St Germain Act in order to provide a cushion against future downturns in the mortgage market—thus resulting in a stronger industry. Even such limited restructuring of the asset base will take time. It is, therefore, important that the bad debt allowance be used in this transition to build a reserve base that will provide stability and strength for the industry and for the financial system as a whole.

Further, the modifications in the bad debt allowance proposed by the National League would clearly restate the public policy expressed time and time again by the Congress—that is, providing a tax incentive for savings and loan investment in housing. This policy is essential if we are to continue to be a nation of homeowners. At the same time, the redefined asset test would recognize the economic reality under which savings and loans are now operating. If we are to survive in the current economic and competitive environment and be able to continue our primary role as residential mortgage lenders, we must diversify the asset base from which we operate.

MORTGAGE INTEREST TAX CREDIT

As a longer-range goal, the National Savings and Loan League has endorsed the concept of a mortgage interest tax credit (MITC). We urge the Congress to examine this concept as a vehicle for increasing investment in housing by other financial entities as well as thrifts.

Under this concept, the percentage-of-taxable-income method of calculating loss reserves for thrift institutions would be eliminated, with further reserve additions on qualifying loans computed under either the percentage-of-eligible-loans or the experience methods presently available to commerical banks. In lieu of the bad debt reserve allowance, we propose a tax credit be granted equal to a specified percentage of gross interest income from qualifying residential mortgages. Essentially, because of the need for stability in the mortgage and housing markets due to their significant and leading influence on the direction and health of the nation's economy, we feel that the credit should be a function of interest income on all qualifying residential mortgage loans. The size of the credit should be a function of the percent of qualifying assets that a financial institution or individual has in its protfolio in order to provide further investment incentive.

The MITC has the following advantages:

(1) The MITC would increase the availability of funds for financing residential mortgage debt.

(2) The mortgage interest tax credit would reduce the net worth constraints which are now and will continue to impinge upon the growth of savings and loan associations.

(3) Third, the MITC would be a move toward reestablishing federal tax equity among competing financial intermediaries.

(4) Unlike the current bad debt allowance provisions, the mortgage interest tax credit is anti-cyclical in that it is a function of interest rates rather than profits.

(5) The mortgage interest tax credit would induce other intermediaries to finance residential mortgage debt, thereby alleviating the growing dependency upon the savings and loan industry as the overwhelming financier of such debt in the future.

The MITC is especially important in light of the demand for housing in the 1980s. As the "baby boomers" reach household formation age, there will be an increased demand for residential mortgage funds which cannot be met by the saving and loan industry alone. This fact was recognized by the President's Commission on Housing, which concluded its work in April of 1982. The final report issued by the Commission recommended that a mortgage interest tax credit be implemented to broaden the range of institutions investing in residential mortgages. While we may not completely share their thoughs on the technical details of how such a tax credit should function, we do share their enthusiasm for creation of an MITC as a vehicle to encourage investment in residential mortgages.

OTHER TAX ISSUES

In addition to the subjects previously mentioned, there are a number of tax issues affecting savings and loans that should be examined on a need or equity basis. Two of these items are briefly outlined below.

1. Net operating loss carryforward

In 1982, the Congress extended the NOL carryforward for commercial enterprises to 15 years. Savings and loans are currently limited to a 5-year carryforward. The National League recommends that the NOL carryforward for savings and loans be extended to 15 years.

2. Investment tax credit

At present, savings and loan associations which may make use of the bad debt deduction are limited to only half of the investment tax credit available to other businesses. Thrifts are the only businesses which are so restricted. The law should be amended to provide the full ITC for thrift institutions.

CONCLUSION

The historical method of taxation of savings and loans has worked to meet the public policy goals outlined by the Congress in 1962 when the basic provisions were enacted. Tax provisions have encouraged the accumulation of reserves and provided incentives for investment in residential mortgages while assuring that savings and loans pay their share of federal income tax.

In the immediate future, the bad debt allowance provisions will continue to foster these public policy goals of incentives for housing and building of reserves if changes are made to allow savings and loans to adapt to current market and economic conditions. These changes would conform tax policy with the statutory changes made by the Congress when it passed the Garn-St Germain Act last year.

At the same time, the Administration, the Congress and the industry should look to the future structure of the savings and loan industry and other financial intermediaries to determine how best to assure accumulation of solid loss reserves and incentives for mortgage investment for all financial intermediaries in a deregulated environment.

I appreciate the opportunity to present the views of the National League and I will be happy to answer any questions.

STATEMENT OF HARRY PRYDE, PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS, WASHINGTON, D.C.

Mr. PRYDE. Mr. Chairman, my name is Harry Pryde. I am a builder from Seattle, Wash. I am testifying on behalf of the more than 105,000 members of the National Association of Home Builders of which I am president.

Before I begin, Mr. Chairman, I would like to commend you for your leadership in getting TEFRA passed last year. It was significant tax legislation which we supported and we oppose efforts to change it.

Our testimony today is based on the need for a steady and stable source of capital for housing. We are especially interested in the 40-percent tax deduction for additions to bad debt reserves that is available to thrifts, provided these institutions maintain a certain level of investment in home mortgage loans and other assets.

NAHB urges the Congress to retain existing requirements mandating current levels of housing loans as a prerequisite for qualification for the deduction unless—and I repeat, unless—Congress is willing to provide alternative tax incentives for investments in home mortgages. The alternative which NAHB suggests is a form of the recommendation of the President's Housing Commission for a mortgage investment tax credit, which would encourage all types of investors to invest in funds for housing.

The Garn-St Germain Depository Institution Act of 1982 provided thrift institutions with the legal authority to completely move out of home mortgages as a source of profit if they so desire. Market data, as shown on table 1 of our testimony, shows that recently saving and loans have been net sellers of mortgages. In 1982, about one-half of the new originations were funded through the secondary market. The major new source of mortgage capital in the future appears to be the secondary market which involves selling pools of mortgages in the form of mortgage securities, including pension funds, insurance companies and others.

So, therefore, the future of the so-called bad debt reserve tax deduction available to thrift institutions is of major interest to housing. In view of the Garn-St Germain Act, thrift institutions have expressed an interest, as you have heard, in retaining the current deduction while reducing the required level of investment in residential real estate loans.

We are vigorously opposed to such action. As has been discussed, new sources of mortgage capital are needed to replace the withdrawal of thrift institutions from the mortgage lending market. As thrift institutions become more profitable, the bad debt reserve deduction remains as one of the last few links between housing and thrift institutions. Therefore, we urge the Congress, as it looks at the taxation of financial institutions, to consider an alternative to the bad debt reserve deduction.

One alternative, which is among NAHB's top legislative priorities, is a mortgage investment tax credit.

Basically, the concept involves a tax credit against taxable income based on the percentage of net new investment in mortgages. The significance of this approach is that it would be available to all types of investors in mortgages and mortgage backed securities, bringing into play the secondary market rather than just limited tax incentives to the thrift institutions.

The principal advantage of this approach is that it provides the flexibility in broadening the scope of incentives to invest in mortgages and mortgage backed securities. It would also make mortgage investments competitive with other types of debt investments and reduce interest rates for home buyers. This is because currently long-term mortgage instruments generally trade at a premium above the interest rates for long corporate debt instruments. The mortgage investment tax credit would reduce this differential.

There are two other major proposals which we believe this committee should consider this year. One involves TIMS, trusts for investment in mortgages, and the other one involves IHA that the chairman introduced 2 years ago, S. 24.

In conclusion, we feel that Congress should only consider eliminating the bad debt deduction in exchange for tax incentives with broader applicability, and particularly in a mortgage investment tax credit, which are more in tune with the current regulatory and investment environment of today.

I thank you, Mr. Chairman, for the opportunity to testify. I would be pleased to answer any questions.

The CHAIRMAN. Thank you.

Mr. Gray.

[The prepared statement of Mr. Harry Pryde follows:]

STATEMENT

OF

THE NATIONAL ASSOCIATION OF HOME BUILDERS

BEFORE THE

FINANCE COMMITTEE

U.S. SENATE

ON

TAX PREFERENCES OF FINANCIAL INSTITUTIONS

MARCH 11, 1983

Mr. Chairman and Members of the Committee:

My name is Harry Pryde, and I am a builder from Seattle, Washington. I am testifying on behalf of the more than 105,000 members of the National Association of Home Builders, (NAHB) of which I am President. NAHB is a trade association of the nation's home building industry. Accompanying me today are Robert Bannister, Senior Staff Vice President for Governmental Affairs, James Schuyler, Staff Vice President and Legislative Counsel, and Ed Beck, Tax Counsel.

I appreciate the opportunity to present our views on tax preferences for financial institutions.

I. INTRODUCTION

NAHB's testimony today is based upon the interest of the housing industry in a steady and stable source of capital for housing. Housing production is closely linked to the ability and willingness of the financial sectors of our country to finance the construction and purchase of homes and rental units. Therefore, although many of the tax preferences which are the subject of this hearing are available only to financial institutions, the tax treatment of financial institutions has implications which extend well beyond the financial sector and affect not only homebuilding but the economy in general.

NAHB is especially interested in the 40 percent tax deduction for additions to bad debt reserves that is available to savings and loan associations and mutual savings banks, provided these institutions maintain a certain level of investment in home mortgage loans and other selected assets. NAHB would urge the Congress to retain existing requirements mandating current levels of housing loans as a prerequisite for qualification for the deduction, unless Congress is willing to provide alternative tax incentives for investments in home mortgages. One particular incentive, which this Committee and the Congress may want to review, as an alternative to the 40 percent bad debt reserve deduction, is the recommendation of the President's Commission on Housing in favor of a mortgage investment tax credit. This would provide investors in mortgage instruments with a tax credit equal to a percentage of their net new investment in mortgages.

Our testimony will examine this concept and in more detail later. At this point, NAHB reaffirms its commitment to the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). This includes provisions to establish withholding on interest and dividends. These provisions were enacted as a way to reduce the federal budget deficit, a major priority of NAHB, and to improve taxpayer compliance. It does not impose a new tax, but only requires prepayment of a tax that is, in all likelihood, owed. And exemptions are provided for those upon whom withholding would be a special hardship. Despite the fact that there are seven bills in the Senate, as of the end of February, and 72 bills in the House of Representatives, for repeal of withholding on interest and dividends, the reasons for implementation of these provisions remain just as valid today as they were in 1982.

II. CURRENT CONDITION OF THE HOUSING INDUSTRY AND HOUSING'S RELATIONSHIP WITH FINANCIAL INSTITUTIONS

The hearings today are highly significant, not only as a means of potentially broadening the tax base through the elimination of tax subsidies, which may be excessive or unnecessary. Also, an examination of current tax rates for financial institutions inevitably leads to a review of the dramatic and far reaching changes which have occurred in the financial sectors of our economy.

While the methodologies involved may not be totally comparable, studies conducted by the Department of Treasury in 1978 and later private studies in 1981 tend to indicate that the effective tax rates on income earned in the U.S. has declined. The Treasury study, which was included in the hearings before the Subcommittee on Energy and Foundations of this Committee, shows that the effective tax rate for banking on U.S. source income was slightly above 18 percent in 1972. A study in 1981, nine years later, prepared by the publication Tax Notes from SEC data, indicates that the average

U.S. tax rate on U.S. income of commercial banks was -12.6 percent -- a negative rate of tax.

This data indicates that financial institutions are able to shelter significant income. But it also demonstrates the effect upon bank profits of the recent economic environment characterized by high interest rates and a high degree of competitiveness for the savings dollar. A seeming paradox exists. Real interest rates are at historically high levels with the spread between inflation and interest rates substantially exceeding the historical spread. However, at the same time, bank profitability had steadily declined until the third quarter of 1982. This data is summarized in Appendix I of our testimony.

There are several explanations for this situation. First, banks and other financial institutions had been required to pay higher interest rates on deposits to be competitive. This has increased the overall cost of money to borrowers. The sharp drop in interest rates during the second half of 1982 reversed the trend.

Second, capital markets are international in nature. Major international banks have absorbed huge amounts of funds created by the rise in the price of oil. But many of the loans made with these funds have been to foreign governments, some of which are now unable to repay. Bank profitability, as the data on profit margins in Appendix I shows, had been at a low level compared with other industries.

We are concerned that the recent increase in profits does not continue to escalate as real interest rates begin to decline.

The difficulties which banks faced have been magnified for thrift institutions. During 1981, S & Ls lost $25.5 billion in deposits, compared to a net inflow of $10.7 billion during 1980. In 1982, S & Ls lost $6.4 billion in deposits. During 1981, the net worth of S & Ls, considered to be a measure of profit and loss, declined by $4.6 billion. During the first half of 1982, the average cost of funds to S & Ls was 11.49 percent compared with an average return on mortgage portfolios of 10.41 percent.

Mutual savings banks have had their reserves eroded by more than three years of disintermediation. In 1981, net outflows were $13.8 billion compared with outflows of $4.9 billion during 1980. Withdrawals exceeded deposits in 1982 by $10.4 billion.

Money market mutual funds, on the other hand, have grown rapidly. From $61.8 billion in December 1980, the fund assets more than tripled, exceeding $229 billion in August, 1982. With financial institutions now able to offer competitive accounts, this trend has reversed with money market funds at a $213 billion level in 1983.

This situation means that thrifts have only high cost short-term funds available and these are not very suitable for housing -- which has implications for the rest of the economy. Thus, in the future, traditional sources of mortgage funds, the thrift institutions, will play a less active role in directly providing funds for housing.

Recent legislative changes have reinforced economic conditions forcing funds out of the housing market.

The Garn/St Germain Depository Institutions Act of 1982 provided thrift institutions with the legal authority to move further away from lending for housing as a source of profit. The legislation expanded the investment powers of thrifts into commercial loans, consumer loans, and non-residential investments. It authorized federal thrifts to offer demand deposit accounts and governmental units NOW accounts. The Act gave thrifts and banks the ability to offer money market instruments, which provide a higher interest rate than savings accounts and are competitive with money market mutual funds.

These changes, while improving the ability of financial institutions to compete for with other forms of funds, increased the cost and instability of their liabilities and led to a movement away from investments in long-term, fixed rate assets such as home loans. Table I shows the extent of this change.

The data shows that savings and loans have withdrawn from their traditional role of providing the housing market with new mortgage money. S & Ls have recently been net sellers of mortgages. This is compared to the activity of mortgage pools which has recently increased substantially.

TABLE I

TOTAL DOLLAR VALUE OF MORTGAGE FUNDS ADVANCED
(in billions of dollars
1976-1982 at annual rate)

HOLDER OF MORTGAGE	1976	1977	1978	1979	1980	1981	1922**
Total Dollar Value	$87.1	$129.9	$151.0	$162.4	$134.0	$115.2	$79.4
Households	7.4	8.4	14.2	20.1	22.2	23.4	20.6
State/Local Govt.	1.3	0.6	2.5	6.3	9.9	7.7	4.0
U.S. Government	0.4	4.2	4.2	6.6	7.5	4.9	4.2
Credit Agencies	2.9	3.5	12.2	14.4	14.1	12.6	20.1
Mortgage Pools	12.2	16.1	13.6	23.1	19.2	15.0	48.4
Private Financial	62.9	97.2	104.3	91.9	61.2	51.5	-17.9
Commercial Banking	15.1	27.7	35.1	30.6	17.8	23.6	11.0
Savings Institutions	49.3	64.9	59.2	47.3	29.0	15.8	-39.5
S & L Associations	44.4	58.2	51.6	43.1	27.9	15.4	-37.8
Mutual Savings Banks	4.4	6.5	7.1	3.6	0.6	-0.1	-2.2
Credit Unions	0.5	0.3	0.6	0.6	0.5	0.5	0.5
Insurance	2.6	5.8	10.2	14.2	14.5	10.3	9.2
Life Insurance	2.4	5.2	9.4	12.6	12.3	8.0	6.1
Pension Funds	*	0.1	0.3	0.3	0.6	0.1	0.7
State/Local Ret.	0.2	0.3	0.5	1.0	1.3	1.8	2.0
Other Insurance	0.1	0.1	*	0.3	0.3	0.4	0.4
Finance Companies	-0.4	1.2	0.9	0.8	0.6	2.9	1.8
REITS	-3.8	-2.4	-1.1	-1.0	-0.7	-1.1	-0.3

* Less than one-tenth of one percent

** Third Quarter Data

Note: Annual data for 1981 is based on an average of the first three quarters of 1981 at seasonally adjusted annual rates.

Source: NAHB Economics Division - Complied from Federal Reserve, Flow Of Funds.

With savings and loans shifting away from housing, alternative sources of capital are needed.

The major new source of mortgage capital in the future appears to be the secondary market which involves selling pools of mortgages in the form of mortgage securities to individual investors, pension funds, insurance companies, and others. Last year about one-half of new originations were funded through the secondary market.

These new capital sources must be induced to commit substantial longterm funds to the mortgage market on a regular basis. Such commitments are necessary if a stable, economic environment is to exist for sustained, non-inflationary growth in housing.

Such a situation is necessary not only for the health of the housing industry, but the overall health of the economy.

It is important to review what has happened to housing over the past several years.

The shortfall of 1.8 million housing units from 1979 through 1982 (based on the 2.0 million level of 1977 and 1978) has cost the nation's economy $233 billion. It has resulted in the loss of:

- 2.8 million jobs;
- $49.2 billion in wages;
- $15.7 billion in combined federal, state and local revenues.

Workers in the construction industry lost ground rapidly in 1982. In February 1983, 1,016,000 wage and salary workers were out of jobs, accounting for approximately one in eleven unemployed workers. The construction unemployment rate was 19.7 percent, considerably higher than the 18.3 percent rate a year earlier and more than twice the 10.4 percent level for the workforce as a whole.

III. TAXATION OF FINANCIAL INSTITUTIONS

The so-called bad debt reserve tax deduction available to thrift institutions is of major interest to housing. Generally, under Sections 166 and 593 of the Internal Revenue Code, savings savings and loan associations and mutual savings banks are permitted to deduct reasonable additions to bad debt reserves in excess of actual loan loss experience and reasonable expectations as to future losses. Savings and loans associations and mutual savings banks may deduct up to 40 percent of taxable income, (as specially defined), provided they maintain a specified percentage of their assets in "qualifying assets", including residential mortgages and other selected investments.

For savings and loans, the qualification level is 82 percent of its assets in residential mortgages. The mutual savings bank must have 72 percent of its assets in these investments to get the full 40 percent deduction. As assets of the institutions drop below the 82 percent and 72 percent levels, the percent of taxable income counted as a reasonable addition diminishes on a sliding scale. If assets in the selected investments go below 60 percent for S & Ls and 50 percent for mutual savings banks, then this method of calculating the addition cannot be used.

In the past, this provision has been a substantial incentive for investment in real property loans since it permits a tax deduction in excess of actual loan loss experience. In terms of revenue loss, according to the 1983 special analysis of the fiscal year 1984 budget prepared by OMB, this provision is equivalent to an outlay of $660 million in FY'82, $680 million in FY'83, and $1.1 billion in FY'84.

In view of the Garn/St Germain Act, the thrift institutions have expressed an interest in retaining the current deduction while reducing the required level of investment in real estate loans.

NAHB is vigorously opposed to such action. As has been discussed, new sources of mortgage capital are needed to replace the withdrawal of thrift institutions from the mortgage lending market. Elimination of current asset investment requirements would only accelerate the flight from mortgage loans without providing any alternative incentives.

NAHB, therefore, urges the Congress as it looks at the taxation of financial institutions to consider an alternative to the bad debt reserve deduction. To build up a new source of capital for housing, all investors in mortgages should be treated equally, rather than a special tax benefit going only to thrift institutions. One alternative, which is among NAHB's top legislative priorities, is a mortgage investment tax credit. The President's Commission on Housing recommended this proposal in conjunction with a gradual phasing out of the 40 percent bad debt reserve deduction. Basically, the concept involves a tax credit against taxable income based upon the level of investments in new residential mortgages. The significance of this approach is that it could be available to all types of investors in mortgages -- i.e. the secondary market, rather than just limited to the current deduction enjoyed by thrift institutions.

The proposal has several key concepts. First, the credit would be available to investments and mortgages made in the secondary market, not just by thrift institutions. Second, the credit would be limited to net new mortgage investments. The level of the credit could be fixed to fit within present budget constraints. Third, it could be combined with the bad debt reserve deduction during a phase-out period. Thrift institutions would be able to elect either the credit or the bad debt reserve deduction.

In structuring the credit, NAHB endorses the general criteria cited by the President's Housing Commission. To accomplish the objective, the credit should have the following features:

- Encourage investors to acquire mortgage assets (loans or pass-through securities) related to investment in housing;
- Encourage additional mortgage investment, rather than reward previous mortgage investments;
- Permit thrift institutions to diversify their portfolios to a certain extent;
- Provide equivalent mortgage investment incentives for all types of investors, including tax-exempt institutions.

The last point is especially important in today's diversified market. A credit geared only to one or a few types of investors, such as depository institutions, will create a two-tiered price and drive away other investors, such as pension funds, thereby defeating the purpose.

The principal advantage of this alternative is its flexibility in broadening the scope of the incentive to invest in mortgages and mortgage backed securities. Such action is a recognition of the realities of today's capital markets and the movement of thrift institutions away from their traditional role as the primary provider of mortgage funds. It would also make mortgage investments competitive with other types of debt investments and reduce the interest rates for the home buyer. This is because, currently, long-term mortgage instruments generally trade at a interest rate premium. For example, Ginnie Mae's, government guaranteed mortgage securities, average 200 basis points above similar Treasury obligations. The mortgage investment credit would reduce this differential, and result in lower FHA/VA mortgage rates for home buyers.

Review of the work done by the Commission and development of a legislative proposal is now in the early stages. NAHB would welcome the opportunity to work with this Committee and its staff in working out a detailed legislative proposal which meets the dual objectives of providing a meaningful replacement for the thrift bad debt reserve and staying within the limits of fiscal responsibility.

NAHB appreciates that the mortgage investment tax credit represents a major shift from the current system of targeting investment incentives to specific types of institutions. This shift is necessary because today's system is dominated, not by specialized financial institutions, but rather by increasingly diversified financial conglomerates. Nonetheless, the Congress may also wish to examine the alternative possibility of continuing to use the bad debt reserve provisions, but tying them more firmly to residential mortgage investment.

The foregoing are suggested approaches to the bad debt reserve deductions which would revise these provisions to meet the changing environment for mortgage credit.

There are two other major proposals which we believe this Committee should enact in the future. These are the Trust for

Investment in Mortgages (TIMS), which the Administration is now developing for submission to the Congress, and the development of the individual retirement account concept to establish a housing account to permit first time home buyers to set aside funds to save for the purchase of their first home.

With regard to the TIMs proposal, statutory and regulatory barriers need to be eliminated for the secondary mortgage market to make use of one of the most promising vechicles available to attract investments into housing. Conventional mortgage-backed securities (CMBS) currently face obstacles that are the result of past policy decisions made before such securities were contemplated. The President's Commission on Housing recommended the elimination of legal, tax and regulatory obstacles to the development of broad markets for CMBS.

The Administration has developed the concept of Trusts for Investments in Mortgages (TIMs) to overcome the obstacles and to make CMBS viable in the capital markets. Conventional mortgage-backed securities designated as TIMs would be relieved from the legal and regulatory barriers to their use. The Administration has already obtained some regulatory changes. The Securities and Exchange Commission agreed to allow simplified shelf registration of CMBS issues. Under the simplified procedure, an issuer must give notice to the SEC but need not obtain approval prior to the sale of an issue.

These and other regulatory changes open the way for CMBS, but that path will only be clear if legislation is enacted to make changes in the tax code to accommodate this new instrument. The

Administration is considering such a proposal and we urge you to work with the Administration for speedy enactment when presented.

IV. CONCLUSION

Since financial institutions, particularly thrifts, are decreasing their role as the primary investors in home mortgages, the continued effectiveness of existing tax incentives intended to encourage investment in home mortgages needs to be carefully evaluated. Currently, savings and loan associations and mutual savings banks may deduct up to 40 percent of taxable income as additions for bad debts, long as a certain percentage of assets are invested in qualifying residential mortgages, and other selected investments. As Congress reviews the taxation of financial institutions, it should carefully assess the extent to which this special tax benefit achieves its stated objective of providing affordable mortgage funds for housing. Congress should consider eliminating this bad debt deduction in exchange for tax incentives of broader applicability, particularly a mortgage investment tax credit along the lines recommended by the President's Commission on Housing, which are more in tune with the current regulatory and investment environment.

APPENDIX I

BANK PROFITS

PROFIT MARGINS OF VARIOUS INDUSTRIES IN THE U.S., Q3 1980-Q3 1982

	Q2 1980	Q2 1981	Q1 1982	Q2 1982	Q3* 1982
Aerospace	3.4%	3.5%	2.6%	2.7%	3.2%
Airlines	N/M	0.7	N/M	1.3	2.0
Appliances	1.6	3.2	2.0	2.2	1.6
Automotive	N/M	1.7	N/M	2.0	N/M
Banks	5.7	4.4	4.4	3.5	5.0
Beverages	6.2	5.4	5.3	5.5	6.1
Building Materials	4.4	3.7	N/M	1.7	3.4
Chemicals	5.6	5.2	5.0	4.2	3.2
Conglomerates	4.6	5.3	3.9	4.2	3.5
Containers	3.3	3.9	1.9	2.9	N/M
Drugs	9.6	9.4	10.5	9.8	10.1
Electronics	5.6	5.2	5.0	5.4	8.3
Food Processing	3.3	3.5	3.2	3.6	3.5
Food and Lodging	7.1	7.9	5.4	6.8	7.0
General Machinery	5.3	5.4	4.5	3.9	N/M
Instruments	5.7	5.4	5.2	5.0	5.3
Leisure Time Ind.	7.8	8.4	6.6	7.3	8.3
Metals and Mining	9.4	6.7	0.2	N/M	N/M
Miscellaneous Mfg.	5.5	6.1	4.3	4.6	4.3
Natural Resources	5.8	5.7	4.2	4.2	4.6
Nonbank Financial	5.8	4.6	4.4	3.6	4.9
Office Equipment	8.7	7.6	7.5	7.7	7.3
Oil Serv. & Supply	12.5	14.0	14.5	13.5	12.0
Paper & Forest	6.1	5.5	3.1	3.4	2.6
Real Este/Housing	3.8	2.6	N/M	1.6	2.5
Retailing (Food)	0.9	0.8	1.3	1.1	1.2
Retailing (NonFood)	1.5	1.8	3.7	0.9	1.8
Savings & Loan	N/M	N/M	N/M	N/M	N/M
Service Industries	3.4	3.0	2.4	2.9	2.7
Special Machinery	5.6	5.9	3.1	1.7	N/M
Steel	2.2	4.0	N/M	N/M	N/M
Textiles, Apparel	3.5	3.4	3.3	2.7	3.5
Tire and Rubber	0.2	3.5	0.5	2.6	2.2
Tobacco	6.0	6.0	6.1	7.5	6.8
Trucking	3.2	4.4	1.0	3.4	3.5
Utilities	9.3	9.0	9.6	9.1	11.2
All Industry Composites	4.8%	5.1%	4.2%	4.3%	4.4%

N/M - Not Meaningful   * Fourth Quarter Data is not available

Source: Business Week, various issues; compiled by NAHB Economics Division

APPENDIX II

The President's Commissic. ..., Housing, Report
(Washington, D.C., 1982) Pg. 78-81, 94-96, 137-146.

Even so, the family will have gained a portion of the appreciated value of the home, which may provide a substantial downpayment on another home. It is essential that a household enter into this type of mortgage only if both the advantages and the risks are fully understood.

A similar idea that deserves attention is shared-equity financing, in which investors other than the homeowner pay part of the downpayment and, if necessary, a portion of the debt service (monthly payments). In return, the investor gains tax advantages including depreciation, plus a share of the home equity. (This type of mortgage has increased in popularity since the 1981 tax law improved the depreciation benefits for residential as well as commercial property.) Under these arrangements, the occupant trades partial ownership in the property for lower monthly payments.

The Downpayment Problem

High house prices are invariably associated with high downpayments. Even if a household has an income sufficient to qualify for a high-rate mortgage, it must accumulate sufficient capital to provide the downpayment on a house. The problem of the downpayment may be mitigated, at least in part, by mortgage insurance, either private or Federal. If the mortgage debt is insured, lenders will allow borrowers to make a lower downpayment, since they need less protection in the form of buyer equity. Although it usually leads to slightly higher monthly payments, mortgage insurance, public or private, can provide significant help in overcoming the hurdle to homeownership represented by the downpayment. Another approach is to encourage would-be homebuyers to accumulate a downpayment by means of tax or other form of incentives. Each of these approaches is discussed below.

Mortgage Insurance

In order to assure the safety of home mortgage loans, lenders typically require downpayments in the amount of 20 to 25 percent of purchase price, so that in the event of default an uninsured loan could be repaid with the proceeds of the sale of the property. This large downpayment can constitute a considerable barrier to first-time homebuyers; mortgage insurance substitutes for this lender-required "equity shield" and allows for much smaller downpayments. While the default risk for an individual loan with a smaller downpayment cannot be borne by an individual lender, the risk can be spread among a number of such loans by mortgage insurance companies, and loans with downpayments of 10 percent or less become feasible. Thus mortgage insurance provides, and should continue to provide, a significant vehicle for lowering the downpayment barrier.

The Federal government has played an important role in this area with the mortgage insurance and guarantee programs of the Federal Housing Administration (FHA) and the Veterans Administration (VA). During the Great Depression, private mortgage insurance disappeared because of falling housing prices, widespread defaults and foreclosures, and the overall state of the economy. FHA revived the notion of mortgage insurance and encouraged the use of the fully amortized, long-term mortgages with moderate down payments—generally averaging 5 percent down, but sometimes as low as 3 percent—thus improving the opportunity of homeownership for many American families.

The lesson of FHA was learned by the private sector. Since the late 1950s private mortgage insurance (PMI) companies have returned as a significant force in the housing market and have been an important factor in allowing lower downpayments. The typical form of private mortgage insurance is 90/20: the loan is restricted to 90 percent of the value of the property, and the top 20 percent is insured against default. Thus private mortgage insurance companies allow for downpayments of 10 percent (and sometimes less, under alternatives to 90/20). By offering mortgage insurance with less than 100 percent coverage and by charging lower premiums than FHA, the private mortgage companies have been able to replace FHA insurance in many cases.

Chapter 12 will discuss the relationship of FHA to the private mortgage industry and outline the Commission's recommendations in this area. In general, the Commission calls for a continuing role for FHA, but with FHA complementing rather than competing with the private market.

Downpayment Assistance for First-Time Homebuyers

The Commission has reviewed a number of alternatives to assist the first-time homebuyer in accumulating a downpayment. It finds the evidence concerning costs and benefits of these alternatives to be inconclusive. Further evaluation is appropriate, and the Commission recommends that three options discussed below be forwarded to the President for full review as to their cost and incremental impact.

If the downpayment necessary for homeownership cannot be reduced enough, the potential homebuyer may need assistance to accumulate the downpayment more rapidly. The exemption from tax of savings earmarked for home purchase and the interest earned on those savings, for example, provide both an inducement to save and greater rewards to saving than under current arrangements. As part of its investigation into ways of encouraging homeownership, the Commission considered the use of the tax system.

An incentive for first-time homebuyers to accumulate a downpayment might take three forms—a separate system of individual housing accounts (IHAs) with contributions eligible for an income tax credit; a separate system of IHAs with Federal matching of contributions to the account; or the modification of the existing individual retirement account (IRA) program so that funds in these accounts could be withdrawn for first-time home purchase. Each option would provide a subsidy for the first-time homebuyer, and each has advantages and drawbacks.

Beginning in 1982, the IRA program allows participation by all wage and salary earners—an almost universal eligibility. This program has important implications for the establishment of a separate IHA program. For lower-income families, IHAs would compete with IRAs for savings, while for higher-income families, they would offer additional tax incentives. The key question is the extent to which potential IHA contributors would also be IRA contributors. With little overlap, opening up IRAs for downpayment purposes would differ little from a separate IHA program with deductible contributions and tax-exempt interest on the account. With substantial overlap, the tax revenue implications and the effect on homeownership may differ considerably from a separate IHA.

Option 1. *A separate system of individual housing accounts, with contributions eligible for a credit against Federal income taxes, and with interest on the account tax exempt.*

The general features of this option include a tax credit for the contribution, tax-exempt interest, and a penalty if the account were used for other purposes. Compared with a deduction for contributions to the IHA, a tax credit provides greater incentives to moderate-income households, who are more likely to need assistance in acquiring a downpayment. A deduction, which necessarily confers greater benefits on those with higher income, would not be as well targeted. A typical IHA program might include provisions such as the following: the program would allow individuals to contribute up to $1,500 annually ($3,000 for a couple) to an account, this contribution forming the basis for a tax credit of 25 percent of the contribution. Those not currently owning a home, and who have never had an IHA in the past, would be eligible to open such accounts, which would terminate when a home were purchased (or after 10 years if no home were purchased). Withdrawals for purposes other than home purchase would be taxed as ordinary income, plus a 10 percent penalty.

One advantage of a separate IHA is that it might appeal to a group different from those saving for retirement, who are attracted to the IRA program. This was the consensus of experts who testified before the Commission's Task Force on Homeownership. A distinct IHA program is able to use a tax credit on contributions, compared to the IRA, which allows contributions to the account to be deducted from income. The IHA with the tax credit feature would be less attractive to higher-income taxpayers than would a deduction, but more attractive to those of moderate income, as previously discussed. Also, the percentage that is allowed for the credit can be adjusted to balance the issues of tax revenue loss and incentives to homebuyers.

Expert opinion is divided on the economic effects of IHAs, that is, the extent to which they permit additional families to become homeowners as opposed to providing subsidies to those who would have bought homes anyway. Clearly, some portion of the tax subsidy would go to those not needing an inducement to homeownership, particularly among higher-income households. For several years, Canada has had a similar program, known as the Registered Home Ownership Savings Plan (RHOSP). This program permits the deduction of up to $1,000 per year from income for deposits into RHOSPs, which are open to anyone not currently owning a home. The increase in homeownership in Canada since the beginning of the RHOSP program has been roughly equal to the trend in the United States, which has no such plan.[3]

Although opinion is divided on the impact of an IHA program on homeownership, estimates of revenue loss to the Treasury for current IHA proposals are much more in agreement. These estimates are based on different proposals, but if adjustments are made to account for differing amounts of contributions allowed, an IHA with deductible contributions of $1,500 per year ($3,000 per couple) would probably cost between $2.5 billion and $4 billion per year after the program had been in existence for a few years. Table 6.1 compares these estimates, of which only Weicher's takes account of the "universal IRA" system now in place. The IRA system will tend to reduce the revenue cost of the IHA, because more IHAs would be opened than if there were no IRA in existence.

All of the above estimates are based on contributions that are deductible from income, and therefore may overestimate the revenue impact associated with the tax credit recommended under Option 1. The Urban Institute compared the effects of a 25 percent tax credit to the deductible contributions evaluated in Table 6.1. As would be expected, there was a considerable redistribution of benefits toward those of lower income, but the overall impact was to reduce revenue losses by about 7 percent per year.

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[3] See John C. Weicher, "The Individual Housing Account: Inferences from the Canadian Experience" (Washington, D.C.: The American Enterprise Institute, February, 1982).

Table 6.1
Tax Revenue Costs of an IHA With Deductible Contributions of $1,500 Per Year ($3,000 per Couple)
(In Billions of Dollars)

	First Year Impact	Long Run Annual Cost
National Association of Homebuilders[1]	—	2.8
Kenneth Rosen[2]	0.6	3.0
Division of Housing Finance, HUD[3]	—	4.5
Urban Institute[4]	2.0	over 3.0
John Weicher[5]	—	2.1–2.8

[1] Testimony of Frank Napolitano, Homeownership Task Force, Dec. 3, 1981

[2] Paper prepared for the Committee on Housing Programs, 1981

[3] Based on estimates by Robert Buckley, prepared in 1977

[4] From the paper entitled "The Desirability of Individual Housing Accounts," by John Tuccillo, July 1981

[5] From the paper entitled "The Individual Housing Account: Inferences from the Canadian Experience," by John C. Weicher, February 1982

Option 2. *A separate system of individual housing accounts, with contributions made from income after taxes to be matched directly on a one-to-four basis using appropriated funds from the Federal government, and all interest on the account fully taxable.*

This option is a version of Option 1, but with two important differences: interest on the account would be taxable, reducing the tax expenditure of this option, and instead of a tax credit, a depositor would receive a grant from the government paid directly into the account.

Because Option 2 calls for appropriations, it could be restricted to some fraction of those who would respond to an entitlement program, although with the attendant problem of rationing the matching grants. As a result, the budgetary cost could be a fraction of that implied by Option 1. Even if Option 2 were proposed as an entitlement program, however, the options differ after the initial contribution, because Option 2 calls for taxable interest as opposed to the tax-exempt interest of Option 1. This feature would eliminate any tax revenue losses associated with the IHA and reduce the overall cost substantially. The total cost to the Federal government is estimated at less than half of the amounts in Table 6.1. At the same time, fewer households might participate, because the benefits would be lower. Compared with Option 1, this approach focuses benefits more closely on those in need of homebuying assistance, because it is less likely to appeal to high tax-bracket households.

Option 3. *Allow tax-free use of funds from individual retirement accounts for the purpose of applying these funds to the downpayment on a first home.*

Under this option, first-time homebuyers could make tax-free "withdrawals" from their IRAs and apply these funds to their downpayment. (This downpayment might be construed as an allowable IRA investment subject to repayment at sale.) The effects of this option on homeownership and tax revenue losses depend on the extent to which potential IHA holders would be IRA holders under the current legislation. Some time will pass before the extent of IRA participation is known, because the full effect of the first year will not be recorded until April 1983.

At one extreme, if potential IHA participants are a different group from IRA holders, the economic effects and the tax revenue effects would be approximately the same as a separate IHA with deductible contributions as shown in Table 6.1. At the other extreme, if all potential IHA holders would otherwise participate fully in the IRA program, the loss in tax revenue would be negligible. The withdrawal would reduce the tax basis of the house, increasing the capital gains subject to taxation if the house were sold and not replaced with another home purchase. Under the IRA as it now stands, withdrawals would be taxed as income, but at postretirement rates (if withdrawn after age 59½). Also, this taxation would occur many years in the future, so that its effect may be similar to the tax on the capital gains on a dwelling.

The overall effect of this option on inducing homeownership is harder to estimate than a separate IHA. Experts differ in their assessments of this impact, because these assessments are based on evaluations of the separate IHA, modified by uncertainty about the use of the IRA program for home purchase.

The main advantage of this option is its relative simplicity. It would require fewer legislative and regulatory changes than a new system of IHAs, although substantial changes would still be required. The IRA system is already established, and modifications of this system would be easier than developing a whole new set of rules and regulations. The primary disadvantage of Option 3 is that the incentive (deduction of deposits from income for tax purposes) is more valuable to higher tax bracket households and does not target benefits to those of moderate income.

The estimates in Table 6.1, with the exception of those made by Weicher, do not account for the existence of the "universal IRA" system now in place. It is likely that the use of the IRA system for home purchase would involve lower revenue costs than those shown in the table. To the extent that an overlap would occur between IHA and IRA holders, use of the IRA for home purchase would result in lower tax revenue losses.

Before turning to possible explicit Federal help for homeowners in saving for downpayments, it is important to recognize three factors that have reduced the real return to savings and that have exacerbated the problem of saving for downpayment. These factors are (1) nominal returns to passbook savings in thrift institutions have been held to levels below what they would have reached as market interest rates have risen with inflation, (2) marginal tax rates paid on all kinds of income increased as taxpayers were pushed into higher tax brackets by inflation, and (3) even though part of the interest paid on any savings is partly an adjustment for inflation, the full amount of the interest is taxed as though all of it were real income. The first two of these have been at least partly corrected. Interest rate ceilings on rates depository institutions may pay are scheduled for eventual elimination, and the Economic Recovery Tax Act of 1981 eliminates future increases in marginal tax rates on ordinary personal income that might otherwise have occurred with inflation.

New Forms and Reduced Cost of Homeownership

The potential for lowering the overall cost of a home, thereby reducing the cash flow burden and the downpayment constraint, should not be overlooked. Many alternatives to traditional home purchase have become quite popular in recent years, including condominiums, cooperatives, and manufactured homes (also known as mobile or modular homes)—all of which provide flexibility and possibly lower costs for homeownership.

Housing quality has increased dramatically over time; home sizes have increased and amenities have proliferated. However, the rise in current cash costs of homeownership may indicate the appropriateness of smaller homes or houses built simply and designed for future expansion or improvement. Another alternative to reduce the cost of housing is the factory-built manufactured house. Certainly the market for low-cost new housing is dominated by manufactured housing, and no discussion of the cost of housing or the availability of homeownership is complete without a discussion of that form of home.

Manufactured houses, though, are not the only means of reducing the costs of homes. Condominiums and cooperatives allow the potential homebuyer the option of purchasing a smaller, full-amenity home at relatively modest cost, and homesteading provides access to relatively large dwellings that have few amenities. One problem with these forms of homeownership is that legal and regulatory barriers have restricted their use for homeownership. Finally, there is the nagging suspicion in the minds of some prospective homebuyers that small, inexpensive, or partially equipped houses are shoddy and will not endure. One way of addressing these doubts is the use of homeowner warranties—a program widely used by the private sector.

In discussing new forms of homeownership, this chapter will examine four areas: condominium and cooperative housing, homesteading, manufactured housing, and warranty insurance on new homes.

Condominium and Cooperative Housing

The Commission recognizes the property rights of owners of rental housing and the substantial benefits to the individual and the community of the homeownership opportunities created by conversion to condominium and cooperative ownership. The Commission has also considered the concerns of tenants affected by such conversion, including the needs of low-income elderly households. On the basis of this analysis, the Commission supports conversion to condominium or cooperative ownership and opposes undue restrictions thereon.

Conversion of multifamily units to cooperatives or condominiums enables many people to become homeowners who otherwise would not have this opportunity. The Commission believes that homeownership is beneficial not only for those who occupy the units, but also to the community as well. The substantial numbers of units that have been purchased under this form of ownership provides evidence of public awareness of the benefits. As the size and nature of households change, the attraction to condominiums and cooperatives is expected to grow.

There are, however, conflicting interests here. The Commission believes that potential homebuyers must continue to be served by the conversion option. Public policy must also protect the rights of apartment owners to dispose of their property. At

Savings and Loan Insurance Corporation, Federal Reserve Board, Comptroller of the Currency, and the National Credit Union Administration. Regulatory agencies may already have the statutory authority to implement such regulations. Should additional authority be needed the President should seek such authority from Congress.

This recommendation would apply to new mortgages created after the effective date of the preemption regulations, and to existing mortgages. However, for property covered by existing mortgages, a phase-in period of up to five years should be provided to ameliorate potential problems of sudden rent increases and tenant displacement. The Commission recognizes that individuals in rent-controlled apartments in some cities might face hardship if rent controls were precipitously terminated. A transition period, including immediate vacancy decontrol when a unit is vacated, is appropriate. The nature of the transition must be tailored to the form of rent control in place in each locality. While a reasonable period of time would be needed for transition, the Commission believes that no more than five years should be allowed before full decontrol is reached on all properties having mortgage loans issued through federally insured lending institutions.

The Commission adopted this proposal in its entirety, although two Commissioners expressed reservations. One reservation was that Federal financial interests in protecting regulated institutions or the Federal liability for insured deposits are not sufficiently direct to warrant the use of preemption. Another was that the preemption should not apply to existing loans, but only to loans issued after the effective date of the preemption provision. If the preemption applied only to such loans, which include many newly constructed buildings, the provision would be easier to implement and administer, because many communities already exempt new construction from rent control.

Tax Incentives

Expensing of Construction Period Interest and Taxes. **All rental housing should be eligible for expensing of interest costs and taxes incurred during construction. Section 189 of the tax code, which requires 10-year amortization of these rental housing expenses except for low-income housing, should be suspended through 1984 to create an incentive for all rental housing production.**

Tax treatment of multifamily new construction has important implications for the owner/developer's equity position. Typically, new rental housing projects are financed through a combination of mortgage financing and equity investment. The equity investment is frequently raised through the sale of shares of a project by the developer to outside or passive investors (limited partners). The equity contributions of the passive investors are an important part of the development incentive in that the amounts invested (contributed to the partnership) may provide an immediate profit to the developer. This happens when the amounts invested exceed the cash needed for the project beyond the mortgage loan. When a passive investor purchases a share of a rental housing project, he or she purchases a share of the tax benefits, net operating income, and expected capital gains associated with the project. The tax benefits for rental housing investment, primarily through accelerated depreciation, allow investors to shelter other income and are a primary incentive for such investment. These benefits are typically larger during the early life of the project and act to somewhat offset the low cash return during the construction period and early "rent-up" period.

Prior to 1976, investors could expense (deduct from current income) construction period interest and taxes. The deduction of these expenses creates an additional source of tax savings for individual investors during the construction period. The 1976 Tax Reform Act eliminated this expensing of construction period interest and taxes for rental housing but not for corporate property. Section 189 of the Internal Revenue Code now requires that, except for low-income housing, these costs be amortized over a 10-year period, rather than deducted in the year incurred. The 10-year spread of deductions has less value to investors than when the expenses can be claimed immediately as a deduction.[5] This change in the tax law may have contributed, along with rising interest rates and decreasing effective demand, to the decline in rental production during the latter part of the 1970s. Restoration of the pre-1976 tax treatment of construction expenses would increase the after-tax return on new rental housing investment, provide comparable treatment for corporate and residential development and therefore provide an incentive at the margin for the production of rental housing.

Expensing of interest costs will be more valuable in periods of high interest rates (since interest costs are higher then) and offset part of the adverse impact of the high financing costs. The Commission believes that this aid is necessary to relieve the current burden of high interest rates from rental production. **The Commission recommends that through 1984 all rental housing should be eligible for expensing of interest costs and taxes incurred during construction. The need for this incentive should be reexamined at that time.**

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[5] An immediate tax savings of $1,000 can earn interest, and is more valuable than a $1,000 tax savings occurring in the future. That is, the present value of current year expensing exceeds the discounted value of the same dollar deductions stretched out over 10 years.

The cost to the Treasury of this incentive likely will be small, and will be offset by the benefits of the incentive. Estimates based on rental housing production and interest rate assumptions as of mid-1981 by the Joint Committee on Taxation indicate that the net revenue loss (difference in discounted present value) will be modest. The Committee estimated that if a general exemption had been made effective as of January 1, 1982 with no sunset provision, revenue losses (in present value terms) would be $113 million in fiscal year 1982 and range between $225 million and $260 million through 1986. These estimates will vary with assumptions made about the interest rate, production, and length of construction period.

Changes in the tax treatment of construction period interest and taxes will primarily affect new production. Another element of the tax code, the granting of tax credits for rehabilitation of real estate, affects existing housing, and if left unchanged, may act as a disincentive to the rehabilitation of rental, as opposed to commercial, structures.

Rehabilitation Tax Credit. **Owners of residential rental structures should enjoy the same investment tax credit for rehabilitation expenses as that for owners of nonresidential real estate.**

Changes in the tax law in the Economic Recovery Tax Act of 1981 provided for special investment tax credits for the rehabilitation of commercial structures. Specifically, the tax code allows for 15 percent credit for structures at least 30 years old, 20 percent for structures at least 40 years old and 25 percent for certified "historic" structures. Other than historic structures, existing residential structures do not qualify for this credit. The unequal treatment of residential and commercial structures may be detrimental to the preservation of existing rental housing.

An extension of the nonresidential rehabilitation tax credit to ordinary rental housing would provide an appropriate, broadly available incentive for investment in rental housing. This incentive would further encourage rehabilitation to be undertaken with funds from the Housing Component of the Community Development Block Grant program. In addition, it would provide a more generally available incentive to upgrade residential property than the accelerated depreciation allowed under Section 167 (k), which is limited to structures occupied by low-income tenants.

An additional rationale for Federal support of existing rental housing exists with respect to the benefits associated with preservation of the rental stock. The problems of abandonment are well known and documented. Not only does abandonment affect residents within a building but it also affects the safety and well-being of neighboring residents and the financial investments of neighboring property owners. Abandonment also frequently endangers Federal investments in low-income areas and may lead to increased municipal expenditures to maintain or demolish abandoned structures. A rehabilitation tax credit, by providing an incentive for upgrading existing units, may reduce some of the problems associated with residential decay and abandonment.

The Department of the Treasury has calculated the increase in project value provided by an extension of the nonresidential rehabilitation tax credit to rental housing. The increase in value resulting from the rehabilitation tax credit, like that for all tax credits, is largely insensitive to the tax bracket of the investor, so long as the investor's tax liability exceeds the credit, but is sensitive to the amount of rehabilitation undertaken. For a project in which rehabilitation costs equal the value of the original structure (the smallest qualifying rehabilitation expenditures under the commercial portion of the 1981 act) the 20 percent credit raises project value 6 to 7 percent. For a more substantial upgrading, where rehabilitation costs are three times the original structure value, the 20 percent credit raises project value 9 to 12 percent. Incentives of these magnitudes should be large enough to encourage the upgrading of deteriorating rental housing.

Because the gain in project value arises from reduced tax liability, the loss of Federal tax revenue approximately equals the gain in the project value. Thus, in the above case where rehabilitation costs equal the value of the original structure, revenue losses to the Treasury would amount to about 6 or 7 percent of total project value. (Revenue losses and value increases cannot be calculated simply as the amount of the tax credit, because other tax advantages, such as accelerated depreciation, are reduced by use of the credit.) Most, but not all, of the revenue loss occurs in the year the rehabilitation takes place. Total revenue losses to the Treasury depend on how many qualifying rehabilitation projects are undertaken as well as the revenue loss per project.

Preservation of the existing housing stock creates housing opportunities for citizens of all income levels. In recent years, there has been a great resurgence in the upgrading and preservation of the existing stock, particularly historic buildings.

Historic Investment Tax Credit. **The Commission recommends that, as part of the certification process for the 25 percent historic investment tax credit, the Secretary of the Interior be authorized to exempt certified historic preservation projects from the substantial rehabilitation test and from the requirement that the building retain at least 75 percent of the existing external walls.**

Recent changes in Federal tax law increase the economic attractiveness of private rehabilitation efforts in connection with historic structures. The Economic Recovery Tax Act of 1981 provides substantial new incentives for rehabilitation of older buildings. As of January 1, 1982, expenditures for qualified housing rehabilitation efforts are eligible for a 25 percent investment tax credit against the owner's tax liability when they take place in an historic structure (of any type, including commercial and residential property) certified by the Secretary of the Interior.

The rehabilitation tax provisions include a test for "substantial rehabilitation" and a requirement for retention of 75 percent of existing exterior walls. In application, it has been discovered that both of these tests have some unintended and undesirable results, which disqualify some historic rehabilitations or unnecessarily increase rehabilitation costs. These problems have been recognized by Congressional tax committees, and several solutions are being considered. The recommendation contains the solution recommended by the National Trust for Historic Preservation as the one most appropriate for preservation needs. For qualifying structures, the proposed treatment would provide a more advantageous alternative than the rehabilitation tax credit in the previous recommendation. It should be recognized that the use of tax credits for rehabilitation of historic structures depends on having a workable system for identifying candidate properties, qualifying entries for the National Register of Historic Places (maintained by the Department of the Interior), and providing technical services to owners of historic structures that are listed in the Register. Further consideration of the role of the National Trust for Historic Preservation and of the role of the existing housing stock is developed in Chapter 8.

Financing and Insurance

An important factor in the ability of the private market to supply rental housing will be the cost and terms of financial capital available for rental housing investment. If the returns to rental housing investment are sufficiently high, funds can be expected to flow from traditional sources, such as life insurance companies and lenders. Proposed modifications in ERISA (see Chapter 11) should make more pension fund resources available for rental investment.

Rental housing benefited from the issuance of fixed-rate, long-term mortgages in the 1960s and early 1970s. Because lenders did not correctly anticipate inflation, most rental projects benefited from the low or even negative real interest payments. Therefore, decreasing real operating returns were offset in part by decreased real interest costs. For the foreseeable future, lenders can be expected to pass the risk of rising interest rates on to investors through fixed-rate mortgages at rates incorporating expectations about inflation or through variable-rate and renegotiable-rate mortgages. This increase in financing costs and interest rate risk may be somewhat offset through shared appreciation mortgages or joint ventures if lenders attempt to share in the returns from rental housing investment. Some improvement in the match, over time, of rental income with mortgage payment expenses might also be realized with graduated payment mortgages, but private lenders have been reluctant to experiment with them.

Insurance is also an important element in the production of multifamily housing. In Chapter 12 the Commission recommends that the FHA should continue to insure unsubsidized multifamily mortgages and should perform a demonstration role with respect to innovative forms of multifamily mortgage instruments. This would include experimental authority for FHA to issue insurance for graduated payment multifamily loans. The Commission also recommends that interest rate ceilings on multifamily mortgages be eliminated and that regulation of developers of FHA projects be minimized.

Regulation

Building Codes. Local land use and building code ordinances inhibit the provision of rental housing and can increase the cost of providing units of rental housing. In Chapter 15 the Commission urges state and local governments with existing building codes to limit building codes to basic health and safety issues and to adopt one of the three nationally recognized model building codes with little or no amendment. This change will reduce the present significant variation among local codes. Standardization of local building codes will allow builders and suppliers to take advantage of economies of scale to serve a larger potential market.

Chapter 16 also recommends that the Department of Housing and Urban Development and the Farmers Home Administration should, in their multifamily condominium and cooperative ownership housing programs and multifamily housing programs, phase out their use of multifamily Minimum

CHAPTER 11

BROADENING PRIVATE SOURCES OF MORTGAGE CREDIT

Greater participation in mortgage investment by private financial institutions with diversified asset portfolios is essential for the broad-based and resilient system of housing finance needed to meet the demands for mortgage credit in the economic environment of the 1980s. Public and private pension funds, commercial banks, life insurance companies, finance companies, and other major sources of capital should play more important roles in the housing finance markets of the future, particularly if the assets of thrift institutions are less concentrated in mortgages and mortgage securities. Mortgage assets can be integral elements of profitable portfolios of many types of institutions, as long as tax, legal, and regulatory factors do not make mortgage instruments unattractive relative to other types of investments available in the market.

As mentioned in Chapter 9, Federal tax policy has been largely responsible for the dominant position of thrift institutions in the private mortgage finance system. Moreover, a variety of legal and regulatory barriers traditionally have interfered with the free flow of funds to the housing markets from many other types of private institutions. In some cases, laws or regulations have limited the investment choices available to specific types of institutions. In addition, legal or regulatory factors have disadvantaged mortgage instruments relative to alternative investments available in the market, thereby deterring all types of private financial institutions with diversified asset portfolios from acquiring mortgage-related securities. Finally, inflation and interest rate volatility have discouraged investors with relatively short-term liability structures from acquiring the long-term, fixed-rate mortgage instruments that have served as the standard form of residential finance for decades.

Various steps toward broadening private sources of mortgage credit are examined in this chapter. The first part describes tax incentives for mortgage investment that currently are available only to thrift institutions and considers extension of mortgage investment incentives to a broad range of private institutions. The second part examines the legal and regulatory barriers that specifically apply to the mortgage investment activities of institutions such as pension funds, commercial banks, and consumer finance companies. The third part identifies changes in existing laws and regulations that are required to create equality between mortgage-related securities and more traditional investment vehicles traded in the nation's financial markets. The fourth part reviews mortgage forms and instruments, giving particular attention to the shortcomings of mortgage forms currently dominant in the market and the need for new instruments that appeal to investors while serving the special needs of borrowers in periods of inflation. The final part considers the role of organized options and futures markets in mortgage securities as ways for mortgage originators and investors to manage interest rate risk without transferring those risks to borrowers.

TAX INCENTIVES FOR MORTGAGE INVESTMENT

The Federal tax code can be used to influence the investment patterns of individuals and institutions and to alter the allocation of capital in the economy

The existing tax law provides a strong incentive for thrift institutions to concentrate their assets in residential mortgage instruments. Some relaxation of these provisions should be part of a coherent public policy to broaden the operations of the thrifts. At the same time, tax incentives for mortgage investment should be provided to a broad range of investors to help ensure an orderly transition to a more broadly based housing finance system. The following discussion examines the special bad debt reserve provisions currently available to thrift institutions and develops recommendations concerning a mortgage interest tax credit for all taxable and tax-exempt institutions.

Special Tax Incentives for Thrifts

Current Federal tax law encourages thrift institutions to invest heavily in residential mortgages.[1] The investment incentive is provided through a special bad debt reserve deduction available only to thrifts. Specifically, Section 593 of the Internal Revenue Code stipulates that a thrift institution may deduct as much as 40 percent of its total taxable income as a noncash addition to its bad debt reserve if a specified percentage of its assets is held in mortgages or other qualifying assets.[2]

To qualify for the maximum 40-percent bad debt deduction, a savings and loan association must hold 82 percent of its total assets in qualifying forms, for mutual savings banks, 72 percent of assets must be in qualifying forms. As the percentage of qualifying assets held by a thrift institution falls, the 40-percent rate is reduced incrementally. For savings and loans, the 40-percent rate is reduced by three-quarters of one percentage point for each percentage point that the ratio of qualifying assets to total assets falls below 82 percent, the special deduction cuts off completely at a 60-percent investment level. For mutual savings banks, the 40-percent rate is reduced one and a half percentage points for each percentage point below 72 percent, cutting off completely at a 50-percent investment level.

The special bad debt reserve provision can place a significant barrier to asset diversification at thrift institutions. To cover the additional taxes incurred through diversification, nonqualifying investments would have to provide net pre-tax yields substantially higher than those available on qualifying assets.[3] As long as financial markets are reasonably efficient, it is difficult, if not impossible, for an investor to find one type of instrument that has an expected net yield consistently higher than another, after taking into account differences in lending and servicing costs, as well as nonrate attributes such as maturity, call or prepayment options, default risk, and liquidity or marketability.

In view of the maturity structure of thrift liabilities and the increased interest rate variability evident in recent years, these institutions might be willing to sacrifice some after-tax yield to reduce interest rate risk, and some cross-selling benefits may be derived from moving into areas such as consumer lending. Asset diversification by thrifts might be quite limited, however, unless they are permitted to qualify for tax advantages at lower levels of mortgage investment.[4] Indeed, the Interagency Task Force on Thrift Institutions noted that retention of the special bad debt provision in its current form could discourage thrifts from using roughly half of the rather modest expansion of asset powers provided by the Depository Institutions Deregulation and Monetary Control Act of 1980.[5]

Aside from constraining the portfolio choices of thrift institutions, the present bad debt deduction has a number of deficiencies as a policy tool. First, the provision clearly provides no incentives for other types of institutions to invest in mortgages or pass-through securities. Second, the benefits afforded by this tax break accrue to thrift institutions and have little or no impact on mortgage rates paid by borrowers; unless the thrifts are able to meet the entire demand for mortgage credit by households (which has not been possible), before-tax mortgage rates are determined in the market by the actions of diversified institutions that operate in both mortgage and bond markets and do not have tax benefits tied to mortgages. Because of the various problems associated with the bad debt provision, alternative tax measures should be considered to permit thrift institutions to diversify their portfolios, to provide mortgage investment incentives to a broad range of institutions, and to channel tax-financed benefits to mortgage borrowers as well as institutions.

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[1] Other types of financial institutions receive tax benefits, but the thrifts are the only institutions whose benefits are tied to mortgages.

[2] Qualifying assets are defined in the Internal Revenue Code as residential real property loans, cash, Federal government obligations, loans secured by members' deposits, loans secured by church, school, health, and welfare facilities, or commercial property located in an urban renewal or model cities area, student loans, and property used in the conduct of the institution's business.

[3] The Interagency Task Force on Thrift Institutions, in *Report of the Interagency Task Force on Thrift Institutions* (Washington, D.C.: U.S. Government Printing Office, June 30, 1980), pp. 109–112, estimated that nonqualifying assets would have to provide a net pre-tax yield 52 percent higher than available on qualifying assets for a savings and loan association to be indifferent to a shift in its qualifying-to-total assets ratio from 82 to 81 percent, nonqualifying assets would have to provide even greater yields, relative to qualifying assets, for an institution to further reduce its ratio.

[4] Some mutual savings banks have given up portions of their tax advantages to diversify their assets. However, many of these savings banks are located in areas where extremely low mortgage rate ceilings and restrictions on purchases of mortgages originated in other States rendered mortgage assets relatively unprofitable, even before interest rates rose to recent high levels.

[5] *Ibid.*

Tax Incentives for All Mortgage Investors

To encourage greater residential mortgage activity by a broad range of institutions, the same tax incentives should be provided to all types of investors through a mortgage interest tax credit (MITC) on income from mortgages or mortgage pass-through securities. Over time, the special bad debt reserve provision for thrifts should be eliminated. The MITC should be considered a transition device, and should be reconsidered in a thorough review of sectoral subsidies in the entire tax system.

As an alternative to special bad debt provisions for thrift institutions, all investors in mortgages or pass-through securities could be permitted to take, as a credit against their tax bills, a specified proportion of interest income from mortgage assets.[8] Eligibility for the MITC and the rate of tax credit could be based on specified criteria concerning mortgage holdings or mortgage acquisitions by investors.

A mortgage interest tax credit is not a new idea. The Commission on Financial Structure and Regulation (Hunt Commission) recommended in 1970 that an MITC equal to a percentage of the interest income earned on residential mortgages be granted to all investors in such loans. This provision was intended as a direct incentive to ensure the flow of capital into housing finance, it was meant to replace the indirect incentive provided through the special provisions for loan losses at thrift institutions; and it was viewed as a way to compensate thrift institutions for the loss of tax benefits arising from elimination of the special bad debt reserve deduction.

The Hunt Commission recommended a multilevel MITC that would provide higher rates of tax credit for institutions with higher percentages of residential mortgages in their asset portfolios, but the commission did not attempt to establish specific rates and investment levels. The Financial Institutions Act of 1975, passed by the Senate but not by the House, would have eliminated the special bad debt allowance for thrifts and made a progressive MITC available to a broad range of investors. The Senate formulation of the MITC, however, had a number of drawbacks. Because of the progressive design, thrift institutions actually would have been discouraged from using the expanded asset powers contained in the act. Moreover, the provision would have provided substantial windfall gains to other types of taxable institutions, such as commercial banks, and little or no mortgage investment incentive for institutions with low- or zero-marginal tax rates, such as life insurance companies and pension funds. Finally, the Senate MITC formula would have rewarded all investment in residential mortgages, not just mortgage credit used to finance investment in housing.

The Commission believes that a broadly based mortgage interest tax credit can be an important device to facilitate the transition to a more resilient and effective housing finance system. Such a tax credit should be designed to include the following general features:

- Encourage investors to acquire mortgage assets (loans or pass-through securities) related to investment in housing.
- Encourage additional mortgage investment, rather than reward previous mortgage investments.
- Permit thrift institutions to diversify their portfolios to a certain extent.
- Provide equivalent mortgage investment incentives for all types of investors, including tax-exempt institutions.

It is not known, at this time, what specific level of MITC would be needed to achieve the desired results. The need, of course, would depend on the degree of asset diversification by thrift institutions and the sensitivity of diversified investors to changes in the relationship between mortgage yields and yields on other capital market instruments.

Eligible Mortgage Assets

Residential mortgage loans, by definition, are secured or collateralized by residential real estate. Mortgage credit, however, need not be used for investment in real estate. Indeed, during the past decade, the volume of mortgage borrowing associated with nonhousing expenditures has expanded as inflation in home prices has greatly increased the market value of the existing housing stock. In this environment, households increasingly have borrowed against equity in the stock of existing homes to finance the purchase of consumer durables, the education of children, and other consumer expenditures. Homeowners have resorted to junior mortgages ("home equity" loans) or have increased the size of outstanding first mortgages through refinancing. Households engaged in the sale and purchase of homes often have "monetized" accumulated equity in homes sold by taking larger mortgages than required on homes purchased.

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[8] If an otherwise profitable institution can minimize its taxable income through the use of tax avoidance devices, the effect of special tax deductions or credits on investment decisions obviously would be lessened. An increase in the authority of thrift institutions to engage in equipment leasing, in conjunction with the leasing provisions of the Economic Recovery Tax Act of 1981, possibly could change the tax status of thrift institutions and alter the effects of the special bad debt reserve provisions on their investment policies. It would be premature, of course, to draw conclusions at this time about the impact of leasing activities on thrift operations over the long run. For instance, competition among lessors (including thrift institutions) could cause a major portion of the tax benefits to accrue to the lessees. Lease payments, for example, could be insufficient to service the debt incurred to purchase capital equipment, requiring the lessor to expend part of the cash flow generated by tax savings to cover the debt payments.

An MITC should encourage investors to acquire mortgage assets that are associated with investment in housing by the ultimate borrowers. One possibility would be to restrict eligibility to first liens, thus preventing the subsidization of junior mortgages used by homeowners to finance consumption expenditures. This restriction, however, also would exclude junior mortgage borrowing for additions and alterations to existing homes. Moreover, limiting eligibility to first mortgages would not exclude mortgage credit raised through first-mortgage refinancing, or the "excess" first-mortgage credit raised by households engaged in home sales and purchases.

New Mortgage Investment

A mortgage interest tax credit should not be keyed to stocks of mortgages held but should encourage additional acquisitions of mortgage assets. Eligibility for the tax credit could be based on gross mortgage acquisitions—originations plus purchases of mortgage assets (loans or pass-through securities). This approach, however, would encourage widespread refinancing of outstanding mortgages and could entail large costs to the Treasury in exchange for little net new mortgage investment.

A preferable approach would condition tax credit eligibility on the net change in mortgage assets held by an investor. For example, credit eligibility could be contingent on achievement of a specified threshold value for a ratio, defined as the change in mortgage assets relative to the change in total assets during a specified period. This approach also would involve some complications. For example, an institution could buy mortgages from another institution unable to avail itself of the credit; such asset swaps could produce revenue losses for the Treasury without an increase in total mortgage investment. Mergers also could present a problem to the extent that surviving firms would qualify for the credit simply because they acquired the mortgages of other firms. Despite such problems, a requirement based on net changes in mortgage holdings would be preferable to criteria based on the level of holdings or gross acquisitions of mortgage assets.

Threshold Levels and Tax-Credit Rates

In designing a tax credit plan, some minimum or "threshold" value for the net change ratio would have to be established to determine eligibility by individual institutions. In addition, tax-credit rates would have to be set to establish the strength of the investment incentives provided by the program. A flat rate of tax credit could be provided for all institutions above a minimum threshold ratio, or higher rates of tax credit could be attached to higher net change ratios.

For the tax credit to provide an effective broad-based investment incentive, the threshold would have to be set low enough to affect the behavior of large numbers of institutions. On the other hand, a low threshold might encourage thrift institutions to reduce substantially and abruptly their mortgage investment activity.

Data from the Federal Home Loan Bank Board (FHLBB) and the Federal Deposit Insurance Corporation (FDIC) provide some basis for evaluating the likely effects of different thresholds. These data indicate the residential mortgage investment activity of commercial banks, mutual savings banks, and savings and loan associations, and measure the change in mortgage holdings as a percentage of the change in total assets.[7]

Annual data for savings and loan associations are displayed in Table 11.1 for the 1976–80 period. The ratio of net mortgage investment to the change in total assets clearly varies with housing and financial market conditions. In 1980—a relatively bad year for housing—little more than half of all savings and loans devoted more than 60 percent of net asset

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[7] The data on mortgage investment do not include mortgage pass-through securities.

Table 11.1
Percent of Savings and Loan Associations with Various Mortgage Acquisition Rates, 1976–80
(Change in Residential Mortgage Assets/Change in Total Assets)

Year	Mortgage Acquisition Rates			
	> 60%	> 50%	> 40%	> 30%
1976	91.3%	94.3%	96.2%	97.4%
1977	94.8	97.1	98.4	99.0
1978	91.9	95.1	97.0	97.7
1979	71.6	78.4	83.1	86.6
1980	54.9	63.4	71.3	77.9

Source: Data compiled by staff from information supplied by the Office of Policy and Economic Research, Federal Home Loan Bank Board.

flows to mortgage lending. In 1977—a year of strong housing activity—nearly 95 percent of all savings and loan associations exceeded that figure. It appears that, for the most part, a threshold ratio set between 30 and 60 percent would cover the vast majority of associations under varying conditions.

For mutual savings banks and commercial banks, the figures are quite different. A high threshold would eliminate a large number of banks. For 1980, 50 percent of all commercial banks devoted less than 10 percent of their net asset flows to residential mortgages, and 50 percent of all mutual savings banks devoted less than 30 percent of their flows to mortgages.[8] Although the ratios for earlier years are higher (thus displaying a pattern similar to savings and loans), in no case do they approach the levels of savings and loan associations. This suggests that a relatively low ceiling would be appropriate for banks.

The data examined suggest two primary options for an eligibility threshold ratio. First, a net investment ratio somewhere in the range of 30 to 50 percent might be established. This approach would affect a large number of small commercial banks that currently devote significant portions of their portfolios to mortgages. Second, a low minimum threshold ratio could be established, with a low rate of tax credit at the minimum level and higher rates at higher ratio levels. Under such a system, however, progression of the tax credit rate should stop below the minimum asset ratios currently prevailing under the bad debt provision for thrift institutions to avoid discouraging portfolio diversification at the thrifts.

The rate of tax credit, under either a flat- or progressive-rate system, initially should be set so as to neutralize the impact of eliminating the special bad debt provision on the net earnings of thrift institutions. To assure that individual thrift institutions do not incur larger tax bills as a result of the switch from the bad debt reserve provision to the mortgage interest tax credit, thrifts should be given the option—for several years—to use either the MITC or the current version of the bad debt provision.

Tax-Exempt Institutions

If a mortgage interest tax credit were made available to all taxable investors, activity by these investors in the markets presumably would lower pre-tax mortgage rates relative to pre-tax yields on other capital market instruments, because taxable institutions, as a group, would be able to meet the total demand for mortgage credit. This result, however, would discourage institutions with low or zero tax rates—such as life insurance companies and pension funds—from moving into mortgage instruments. Thus, to broaden the base of mortgage supply to include tax-exempt institutions, it would be necessary to make the benefits of the MITC available to them.

Tax incentives for mortgage investment could be extended to tax-exempt institutions in several ways. A refundable credit is the most direct method: a pension fund that engages in a sufficient amount of mortgage investment to meet the threshold requirements of the tax credit provision would receive a payment from the Treasury equal to the credit that could have been claimed by a taxpaying institution. A second option would structure the mortgage instrument so that a pension fund that bought the instrument from a taxable mortgage originator would be able to capture some or all of the benefit. In effect, the originator would sell the mortgage instrument at a discount and retain the rights to the tax credit.

Review of Tax Incentives and the Tax System

Special sectoral tax incentives—whether for housing or other industries—are unnecessary when markets work efficiently to allocate resources. During the next several years, however, the housing finance system undoubtedly will change in dramatic and unpredictable ways, and the traditional strong reliance on specialized mortgage finance institutions probably will decline.

The tax incentives for mortgage investment recommended above are designed to help the nation navigate this difficult transition period without shortfalls in the supply of mortgage funds; thus, these incentives should be considered temporary and should be reconsidered when a thorough review of sectoral subsidies in the entire tax system is conducted. Eventually, it may be possible to eliminate all special investment incentives as the efficiency of private financial markets improves. The recommendations presented in the remainder of this chapter have been designed to help move the nation toward that goal.

INSTITUTIONAL SOURCES

The broad-based tax incentives discussed above are intended to attract a wide range of diversified private institutions into residential mortgage investments. The investment policies of some major types of institutions, however, are circumscribed by laws or regulations established at the Federal or State level. The following discussion focuses on legal or regulatory constraints on housing investments by private and public pension funds (including those at life subject only to the regulations of their respective regulatory supervisors and deposit insurers.

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[8] Data supplied by the Federal Deposit Insurance Corporation.

Consumer Finance Companies

Participation by consumer finance companies in the nation's housing finance system could provide another important source of funds for housing. Entry into the housing finance market by these institutions would increase competition, and the demonstrated access to national capital markets by consumer finance companies would provide a major and flexible source of housing credit.

Finance companies already have shifted to some degree from traditional small, secured and unsecured consumer loans to larger real estate-secured loans. It is estimated that more than 50 percent of total secured loans held by consumer finance companies at the end of 1980 were collateralized by real estate—compared with 38 percent in 1979 and 26 percent in 1978.[13] 3 In many areas, however, the State laws under which finance companies operate are either restrictive or ambiguous concerning the authority of the companies to acquire mortgage loans. Because many of the largest consumer finance companies operate nationwide or have regional branch structures, ambiguities or restrictions at the State level should be removed.

The Commission supports changes in State laws and regulations to facilitate the entry of consumer finance companies into the housing finance system. States should review regulations or statutory prohibitions against dual business and licensing restrictions that impede entry, and should remove restrictions on investment activities that limit acquisitions of residential mortgage assets by consumer finance companies. Currently, limitations on loan size and maturity inhibit consumer finance company investment in first mortgages in many States.

CONVENTIONAL MORTGAGE-BACKED SECURITIES

Mortgage-related securities issued for sale in the secondary market currently are disadvantaged from a legal, regulatory, and tax standpoint in their competition with corporate debt obligations, unless the securities are covered by the guarantee of a Federal or federally related agency. These disadvantages could become increasingly important impediments to the free flow of mortgage credit through the nation's capital markets, particularly if thrift institutions become less important as mortgage investors and Federal participation in the nation's credit markets is reduced as a matter of public policy.

The disadvantages faced by private mortgage-backed securities appear to be largely inadvertent consequences of past policy decisions. Legal and tax problems have arisen partly because mortgage-related securities did not exist or were not contemplated when laws governing investments and investment vehicles were written. In some cases where statutory impediments to trading mortgage securities were not codified, regulatory barriers have been imposed—again, partly because of ignorance of the true nature of these securities or failure to recognize certain realities of the mortgage finance marketplace. As a matter of public policy, legal, regulatory, and tax impediments to the development of broad and active markets for conventional mortgage-backed securities should be eliminated.

There is a consensus in the investment community that an active CMBS market cannot develop until a proper tax, regulatory, and market climate is established. Recommendations made earlier in this chapter concerning ERISA and related Department of Labor regulations, as well as the recommendations concerning extension of tax incentives for mortgage investment to taxable and tax-exempt institutions, could spur the development of CMBS markets.

The following discussion identifies additional adjustments that should be made to laws and regulations to foster development of the CMBS market: revisions to the Federal tax code, modifications to Federal regulations concerning the registration of securities and issuers, changes in Federal Reserve regulations governing the purchase of securities on margin, changes in the Federal bankruptcy code, and modifications to State legal investment statutes and blue-sky laws. The discussion also considers ways to promote standardization of CMBSs, including more widespread use of State housing finance agencies as CMBS issuers and Federal creation of CMBS vehicles with minimum reserve standards to cover credit risk and issuer performance.

Revisions to the Tax Code

The Internal Revenue Code should be amended to provide an exemption for conventional mortgage-backed securities from taxation at the pool issuer level, provided the CMBSs meet minimum criteria. The Internal Revenue Code should also be amended to treat the recovery of market discounts on CMBSs on the same basis as such discounts are treated on corporate securities.

Section 851 of the Internal Revenue Code (IRC) provides that the income of a regulated investment company (mutual fund) is subject to taxation only at the shareholder level, because it receives a deduction for dividends paid to shareholders. In contrast, a CMBS could be taxed at both the pool- and certificate-holder levels, even though all net income is passed through to the certificate holder. Unless CMBS pools are fixed at the outset, are self-liquidating, and have no active management, there is a significant danger that a Federal income tax liability would be incurred at the issuer or pool level.

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[13] Data supplied by the National Consumer Finance Association.

This constraint has resulted in almost universal use of the "grantor trust" device in the administration of CMBS pools. The grantor trust format is an inflexible tool that produces mortgage-investment instruments with certain limitations. Active management, including the ability to substitute loans, to reinvest principal payments (either in new mortgage assets or under an investment contract), or to alter the pool after formation, generally is impossible. Combined with the monthly payment schedules and prepayment uncertainties inherent in mortgages within the pools, the requirement of passive management results in an unattractive instrument for many investors. Return of principal in small or unpredictable amounts creates reinvestment concerns about timing, investment options, and yield.

The CMBS market clearly needs greater flexibility in pool management to reach a broader range of investors without the danger of taxation at the pool/issuer level. Fears of taxation at the pool level have inhibited use of innovative securities tailored to the particular needs of investors. Issuers should be able to offer various types of instruments, such as those that apply early principal repayments and prepayments to purchases of additional mortgages, and so-called "fast pay–slow pay" pools, in which one group of certificate holders receives all payments of principal until its certificates are retired, thereby insulating the second group from early retirement of its investments.

The tax code treatment of gains and losses of principal also is unfavorable to CMBSs. The IRC stipulates that investors in corporate obligations may treat the recovery of discounts (other than original-issue discounts) on sale or retirement as capital gains, rather than as ordinary income. CMBSs, however, are considered by the Internal Revenue Service to represent the obligations of individual mortgagors, and thus the securities are not entitled to the favorable treatment available to corporate obligations under the IRC; in effect, CMBS holders are required to treat the recovery of all discounts through principal payments as ordinary income. This restriction places deeply discounted low-coupon mortgage securities at a particularly competitive disadvantage in the general capital markets, even though certain investors would otherwise seek to acquire such securities.

Registration of Securities and Issuers

The Securities and Exchange Commission should promulgate regulations to provide specific and streamlined shelf-registration procedures designed for conventional mortgage-backed security issues.

CMBS issuers should be permitted, but not required, to register as regulated investment companies.

Some private issuers of CMBSs have taken advantage of the general shelf-registration procedures of the Securities and Exchange Commission (SEC). Shelf registration is useful to an issuer where disclosure materials remain unchanged from one pool to the next. Unlike corporate entities, CMBS issuers that continually originate and pool mortgages generally produce a series of similar issues over a relatively short period of time. However, if certain pool characteristics change, regardless of how minor the change may be, new registration may be required. This re-registration process is costly and creates undue delays when rapid opinions and responses may be necessary to take advantage of changing market conditions. Therefore, the SEC should develop a streamlined shelf-registration procedure that provides issuers with prompt clearances for both initial and subsequent issues of CMBSs.

Private CMBS issuers might find it desirable to register as regulated investment companies under the Investment Company Act of 1940. By such registration, CMBS issuers would not have to register individual issues and would be permitted greater flexibility in pool management. The act is not applicable to mortgage investment vehicles, however, and the SEC has refused Investment Company Act filings for issuers of mortgage-backed securities. To achieve parity, CMBS issuers should, by amendment to the Investment Company Act of 1940, be permitted—but not required—to register as regulated investment companies.

Purchase of Securities on Margin

The Federal Reserve Board should amend Regulation T to allow for the purchase of privately issued conventional mortgage-backed securities on margin.

Regulation T of the Federal Reserve Board permits a securities broker or dealer to extend credit on the collateral of corporate securities, and Regulation U of the Federal Reserve Board applies to similar extensions of credit by commercial banks. The process of extending credit on the collateral of securities is termed "lending on margin" and the regulations issued by the Federal Reserve Board

STATEMENT OF HERBERT W. GRAY, CHAIRMAN, NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS, NEW YORK, N.Y.

Mr. GRAY. Mr. Chairman, Senator Long, my name is Herbert Gray. I am chairman of the National Association of Mutual Savings Banks and chairman of the Mutual Bank for Savings in Boston. I appreciate the opportunity to appear before this committee to discuss the taxation of savings banks. Our industry strongly supports the view that all industries, financial or otherwise, should pay their fair share of taxes. It is the same view expressed in the chairman's February 22 statement announcing these hearings. And we are happy to cooperate with the committee in any way we can to achieve this objective.

Under present law, and as has already been indicated, savings banks and savings and loan associations are permitted to utilize a special thrift institution bad debt reserve formula. This formula was adopted by Congress in 1969 in light of the mortgage lending role of thrift institutions. It is available to a savings bank only at a price—the institution's willingness to comply with a restrictive, housing-oriented investment standard that excludes various attractive types of investments authorized by recent banking legislation. Furthermore, thrift institutions are subject to more restrictives tax provisions than other corporate taxpayers in a number of areas.

As long as savings banks were profitable, they paid sharply increased amounts of Federal tax and had an increased effective tax rate as a result of the adoption of the present tax provisions in 1969. Tax increases were built in by the 10-year phase-down in the bad debt deduction adopted as part of that legislation. The benefits of the deduction have been effectively reduced even further because of the impact of the minimum tax and the 15-percent reduction in tax preference items in the 1982 tax legislation.

The tax situation of savings banks was drastically altered by rapidly escalating interest rates in 1980 to 1982. Our industry, like the savings and loan industry, suffered enormous losses and, as a practical matter, the question of income taxation became and remains essentially moot. In order to address the gravely weakened condition of the thrift industry, the Congress adopted the Garn-St Germain Depository Institutions Act of 1982 which provides shortrun net worth assistance while expanding the nonmortgage powers of thrift institutions to strengthen their longrun viability.

In an improved financial environment, savings banks will gradually be restored to profitability and, hopefully, we will be able to shore up badly depleted reserve positions. The tax laws should encourage this trend so that the thrift industry will be able to reduce its reliance on Federal net worth assistance, resume its vital role in financing the Nation's capital needs and generate increased earnings and, consequently, increased tax revenue. This is of particular importance in the case of mutual institutions which have no way to rebuild net worth except through retained earnings. In this regard, consideration should be given to a number of changes in the current tax provisions governing thrift institutions. As indicated in my full statement, these areas include the investment tax credit, the operating loss carry forward and the present restrictive investment standards for institutions using the thrift industry bad debt reserve position, which unchanged, and despite the testimony of Mr. Pryde, could well discourage mortgage lending rather than stimulate it.

Under the best of circumstances, numerous institutions will continue to operate in a weakened condition and with low capital positions for some time, possibly years to come. Any attempt to increase thrift institution taxation would merely retard the industry's return to health and viability, limit its ability to serve the needs of the communities in which its institutions are located, and prolong the dependence of individual institutions on Federal assistance. A healthy savings bank industry will help this country solve its problem in generating capital, and in the process, based on past experience, pay its fair share of taxes as determined by public policy desires of Congress. And I think that is an important point.

Thank you for the opportunity to present our position on these issues. I would be happy to answer questions.

[The prepared statement of Mr. Herbert W. Gray follows:]

Statement
of the
National Association of Mutual Savings Banks
on the
Taxation of Savings Banks
before the
Committee on Finance
United States Senate
March 11, 1983

Summary of Principal Points

Under the present federal income tax provisions, savings banks are permitted to utilize a special thrift institution bad debt reserve formula, which was adopted by the Congress in 1969 in light of the mortgage lending role of thrift institutions. The provision is available to a thrift institution only if it complies with a housing-oriented investment standard that excludes various attractive types of investments authorized by recent banking legislation. Furthermore, thrift institutions are subject to more restrictive tax provisions than other corporate taxpayers in a number of areas.

As long as savings banks were profitable, they paid sharply increased amounts of federal tax and an increased effective tax rate as a result of the adoption of the 1969 legislation. This situation was drastically altered by skyrocketing interest rates in 1980-82, which resulted in enormous earnings losses at savings banks. In addressing the weakened condition of the thrift industry, the Congress adopted a net worth assistance program as part of the Garn-St Germain Depository Institutions Act of 1982.

In a reduced interest rate climate, savings banks will gradually be restored to profitability and will be able to shore up badly depleted reserve positions. The tax laws should encourage this trend, so that the thrift industry will be able to resume its vital role in financing the nation's capital needs and generate increased earnings and tax revenue. On the other hand, any increase in thrift institution taxation would merely retard the industry's return to health and viability, and prolong the dependence of individual institutions on federal assistance.

Statement
# of the
National Association of Mutual Savings Banks
on the
Taxation of Savings Banks
before the
Committee on Finance
United States Senate
March 11, 1983

Mr. Chairman and members of the Committee, my name is Herbert W. Gray. I am Chairman of the National Association of Mutual Savings Banks and Chairman of the Mutual Bank For Savings in Boston, Massachusetts. The National Association represents the more than 400 savings banks in the nation. In the areas where they are most heavily concentrated, savings banks are the largest holders of consumer savings as well as the dominant mortgage lenders among the various types of depository institutions. Savings banks are basically community-oriented financial institutions. The industry's assets total about $175 billion.

I appreciate the opportunity to appear before this Committee to discuss the taxation of savings banks. Our Association strongly supports the view that all industries should pay their fair share, as expressed in the Chairman's February 22 statement announcing these hearings. We are happy to cooperate with the Committee to achieve this objective.

Our views on savings bank taxation may be outlined as follows:

1. Under the present federal income tax provisions adopted in 1969, savings banks and savings and loan associations are permitted to utilize a special thrift institution bad debt reserve formula. This formula was adopted by the Congress in light of the mortgage lending role of savings banks and savings and loan associations. It is available to a thrift institution only at a price -- that institution's willingness to comply with a restrictive, housing-oriented investment standard that excludes various attractive types of investments authorized by recent banking legislation.

Furthermore, thrift institutions are subject to more restrictive tax provisions than other corporate taxpayers in a number of areas -- the investment tax credit, the dividends received deduction and the operating loss carryforward.

2. As long as savings banks were profitable, they paid sharply increased amounts of federal tax and an increased effective tax rate as a result of the adoption of the present tax provisions in 1969. Tax increases were built in by the ten-year phase-down in the bad debt deduction adopted as part of that legislation. The deduction has been effectively reduced even further because of the impact of the minimum tax, and the 15 per cent reduction in "tax preference" items in the 1982 tax legislation.

3. The tax situation of savings banks was drastically altered by rapidly escalating interest rates in 1980-82. As a result, the industry suffered enormous losses and, as a practical matter, the question of income taxation became essentially moot. In order to address the gravely weakened condition of the thrift industry, the Congress adopted a net worth assistance program as part of the Garn-St Germain Depository Institutions Act of 1982.

4. In an improved financial environment, savings banks will gradually be restored to profitability and will be able to shore up badly depleted reserve positions. The tax laws should encourage this trend, so that the thrift industry will be able to reduce its reliance on federal net worth assistance, resume its vital role in financing the nation's capital needs and generate increased earnings and tax revenue. In this regard, consideration should be given to a number of changes in the current tax provisions governing thrift institutions, as discussed later in this statement. On the other hand, any increase in thrift institution taxation would merely retard the industry's return to health and viability, and prolong dependence on federal aid.

Savings Bank Tax Provisions

In developing tax provisions for savings banks, the Congress has always recognized the basic characteristics and economic role of these institutions.

In 1951, when savings banks and savings and loan associations were first made subject to federal income taxation, the Congress was primarily concerned with the mutual form of organization of most thrift institutions. Accordingly, the Congress developed a special bad debt reserve provision which provided that thrift institutions would not pay tax unless their total surplus, undivided profits and reserves exceeded 12 per cent of deposits.

In 1962, new reserve provisions were adopted. At that time, the Congress was concerned primarily with housing -- the desirability of stimulating mortgage flows and assuring reserves appropriate to the needs of thrift institutions. This concern was reflected in the statement by the House Ways and Means Committee that: "...the bill provides reserves consistent with the proper protection of the institution and its [depositors] in the light of the peculiar risks of long-term lending on residential real estate which is the principal function of these institutions." 1/

In 1969, when the present formula was adopted, the Finance Committee continued to recognize the need for "...reserves consistent with the proper protection of the institution...in light of the peculiar risks of long-term lending on residential real estate..."2/ At the same time, bad debt reserve provisions were reduced in order to increase taxation of both thrift institutions and commercial banks.

1/ Revenue Act of 1962, Report of the Committee on Ways and Means, House of Representatives, House Report No. 1447, 87th Congress, 2nd Session, March 16, 1962, p. 33.

2/ Tax Reform Act of 1969, Report of the Committee on Finance, United States Senate, Report No. 91-552, 91st Congress, 1st Session, November 31, 1969, p. 162

The formula adopted in 1969 permits thrift institutions to calculate bad debt reserve deductions under three alternatives: (1) experience, (2) percentage of eligible loans ("commercial bank method"); and (3) percentage of income ("thrift institution method"). In 1969, the allowance under the thrift institution method was 60 per cent of net income, but this was phased down according to a prearranged schedule to 40 per cent in 1979 and later years. The benefits of the thrift institution allowance have been further reduced by the imposition of the minimum tax, and by the 15 per cent reduction in so-called items of "tax preference" adopted in the 1982 tax legislation.

In order to be eligible for the thrift institution bad debt reserve provision, a savings bank must have a specified percentage of its total assets in residential mortgage loans and other qualifying assets. Thus, a savings bank must have at least 60 per cent in qualifying assets to be eligible for any deduction at all, and must have 72 per cent (82 per cent for stock savings banks) to obtain the maximum allowable deduction. Qualifying assets exclude many types of investments such as business and consumer loans which thrift institutions were authorized to make by recent banking legislation. In addition, an institution utilizing the thrift institution bad debt reserve formula is not eligible for the full 85 per cent dividends received deduction available to other corporate taxpayers, but has a substantially reduced deduction depending on its bad debt reserve allowance.

The tax laws restrict thrift institutions in other ways as well. Thrift institutions are eligible for only 50 per cent of the investment tax credit available to other corporate taxpayers. And this is true whether the thrift institution is taxed under the special thrift bad debt reserve method or under the experience method like any other taxpayer.

Furthermore, thrift and other financial institutions are subject to different operating loss carry-over provisions than other corporations. Financial institutions can carry operating losses back for 10 years and forward for 5 years. Other businesses are permitted a 3-year carryback and a 15-year carryforward. Thus, the carryover period for financial institutions is shorter than for other taxpayers, 15 years compared with 18 years. Furthermore, many savings banks have had such enormous losses in the recent high-interest-rate period that they have already offset income from past years and have additional large losses to carry forward to the future. Unless the carryforward period is lengthened, these institutions will lose the benefit of loss carryforwards.

In short, savings banks and savings and loan associations have the benefit of a special bad debt reserve provision which the Congress adopted in light of the special needs and economic functions of these institutions. At the same time, thrift institutions are subject to various tax restrictions not applicable to other taxpayers that will reduce their ability to strengthen earnings, repay federal assistance, restructure assets and thereby assure their long-run viability.

Experience Under Present Law

As noted earlier, the 1969 changes in bad debt reserve provisions were designed to increase tax payments of thrift institutions and commercial banks. As far as thrift institutions are concerned, the 1969 changes clearly succeeded in that purpose.

As shown in the accompanying table, federal income tax payments of savings banks increased sharply from $16 million in 1969 to $200 million in 1978, when net income reached a peak. Tax payments declined somewhat in 1979 as net income diminished, but still remained high. This era came to an abrupt end, however, as earnings plummetted in the face of sharply escalating interest rates. As a result, the industry suffered net losses before federal income taxes amounting to about $3.5 billion in 1980, 1981 and 1982 combined.

Similar trends are evident in terms of effective tax rates. On this basis, the effective federal income tax rate of savings banks increased from 6.0 per cent in 1969 to a high of 21.6 per cent in 1974. It was 17.3 per cent in 1979, just before the industry's bottom line plunged rapidly into the red.

From these data, it should be clear that the present savings bank tax provisions were effective in achieving the revenue-raising objective that the Congress had in mind in adopting these provisions in 1969. As long as savings banks had profits, they paid a sharply increased amount of federal income ax, and an increased effective tax rate, as compared with the situation existing in 1969 and earlier years.

Possible Changes in Savings Bank Taxation

Any consideration of changes in savings bank taxation should give appropriate recognition to the current condition of the industry. Tax changes should also be consistent with the revolutionary changes underway in the thrift industry as a result of the Garn-St Germain Depository Institutions Act.

Currently, earnings positions of savings banks are strengthening as a result of the reduction in interest rates in late 1982. A return to profitability, however, is clearly contingent on the maintenance of interest rates at relatively low and stable levels. Even in a fairly favorable financial market environment, moreover, savings banks face a formidable task in generating positive net income and rebuilding capital positions. For example, the explosive growth of money market deposit accounts, as well as other deposit deregulation actions which may be taken by the Depository Institutions Deregulation Committee, will tend to raise deposit costs by stimulating major shifts from lower-rate deposits.

Under the best of circumstances, numerous institutions will continue to operate at a loss and suffer capital erosion for some time. In order to stay in business, some institutions will have to utilize net worth assistance from the federal deposit insurance agencies, as provided under the Garn-St Germain Act. In the short period since the Act was adopted last October, 15 savings banks have received $175 million of assistance, through the exchange of net worth certificates issued by the banks for promissory notes issued by the FDIC.

In addition to providing short-run assistance, the Garn-St Germain Act authorized broadened nonmortgage powers for federal thrift institutions. Greater asset flexibility will eventually enable thrift institutions to restructure their portfolios and help keep them viable in future periods of high interest rates.

Against this background, tax changes could improve the short- and long-run strength of the savings bank industry consistent with Congressional policy as reflected in the Garn-St Germain Act. For example, providing thrift institutions with the same investment tax credit available to other corporations would help them to make the additional investments in equipment needed in light of ongoing developments in transactions deposit markets and electronic funds transfer systems.

Lengthening the current 5-year operating loss carryforward period for financial institutions would be more in line with the provision available to other corporate taxpayers. It would be highly useful to those thrift institutions which have already exhausted opportunities for carrying losses back to earlier years. An extended carryforward period would hasten the rebuilding of capital positions.

Finally, reduction of the present restrictive tax investment standard would encourage thrift institutions to utilize the broadened powers authorized by the Garn-St Germain Act, while maintaining a substantial position in mortgage lending.

Any increase in taxation would, of course, have quite different results. Such action would merely slow down improvements in the earnings and capital positions of savings banks, and prolong the period during which some institutions will have to rely on federal assistance.

I hope these comments will be helpful to the Committee.

Table 1

Federal Income Taxes and Effective Tax Rates of Savings Banks 1969-82

(Amounts in millions of dollars)

Year	Federal income tax	Net income before tax	Federal income tax as per cent of net income before federal tax
1969	$ 16	$ 271	6.0%
1970	28	236	12.0
1971	70	478	14.7
1972	119	689	17.3
1973	135	696	19.4
1974	104	481	21.6
1975	79	520	15.1
1976	118	694	17.0
1977	155	933	16.6
1978	200	1,094	18.3
1979	155	896	17.3
1980	--	-284	--
1981	--	-1,685	--
1982(p)	--	-1,500	--

p - Preliminary.
Source: National Association of Mutual Savings Banks.

The **Chairman**. Thank you, Mr. Gray. Senator Long.

Senator **Long**. No questions. Thank you very much, Mr. Gray. That was a good statement.

The **Chairman**. I think what we may do, rather than retain you any longer, since I was the one who was late, maybe submit questions in writing. But I would like to just ask a couple of questions. But if you would be willing to respond to some written questions to help make the record, it would be very helpful.

You have heard the testimony this morning from the Treasury Department and credit union representatives. Does the U.S. League have any position on the tax exemption for credit unions? And if you do not have, or if you do have, do you belive that the complete tax exemption gives credit unions a competitive advantage over your members?

Mr. **Green**. Mr. Chairman, we take no position on that issue. We do understand the reasons that this committee should look at it on an equity basis. They do have some competitive advantage because of their tax situation.

The **Chairman**. And we have been asked—and again without getting into the present debate. This has been raised from time to time—if there is not a considerable Federal subsidies for mortgage lending embodied in Federal regulations prohibiting small investors from maintaining money market or money fund accounts without a $2,500 minimum balance. I understand the U.S. League of Savings, a national league, lobbied for a high minimum deposit requirement to protect thrift institutions and having highly profitable passbook savings converted into deposit bearing fair market rates of interest. Do you have any comment on that? Is there any justification for a $2,500 minimum?

Mr. **Green**. Well, Mr. Chairman, there are some other accounts which are very profitable accounts that have no minimums whatsoever, or a $100 minimum. The 2½-year small savers certificate account is a very profitable account for the small saver, and has over the last few months and years, been probably the most prevalent of the higher-paying accounts. And this is a small saver item.

I think that what we were pushing for in suggesting a minimum for money market deposit accounts was some reasonable phase-in period where our industry could assimilate the tremendously high cost of the new money market accounts. And this was a mechanism which we felt would be useful in that assimilation of those higher costs, Mr. Chairman.

The **Chairman**. You wouldn't have any objection if we lowered that $2,500 by statute?

Mr. **Green**. Well, we certainly would hope that a reasonable timing mechanism is there. The whole thing goes out, according to law, in early 1985, as I recall, sir.

Mr. **Pryde**. I want to slightly elaborate, Mr. Chairman, and echo most of what Mr. Green has said, and go on to say that what has happened, of which you all are fully aware in this committee, is there has been almost instantaneous deregulation on the liability side of an asset/liability balance sheet. There has not been sufficient time for the asset side of the balance sheet, for investments, to catch up to deregulation on the other side of the equation.

The National League is in favor of deregulation, but we believe that further deregulation, for example, in the liability area at this time will not serve the best interest of the country for the simple reason it is going to have the sole effect of raising interest rates in the short run.

The **CHAIRMAN**. I find that hard to correlate with some of the information I received on withholding, when there is concern about 50 cents per thousand; that you do not have that same concern about your depositors or savers in this area. I have trouble trying to reconcile the two. How you can condemn withholding as an expense to your customer, but not let them enjoy the higher rate for those who do not have the $2,500.

Mr. **GREENE**. Well, sir, if I could, two issues, I think, are somewhat separate. The $2,500 issue, I believe does relate to higher interest rates that would be passed on to the other side of the consumer equation, namely, the borrowers as opposed to the savers. Deregulation is going to happen anyway, as has been pointed out, in 1985 the current program simply gives a little bit of time for the asset side of the equation to catch up.

Mr. **GRAY**. I would like to add, insofar as passbook accounts are concerned, that in reality when we begin to look at the future, and the fact that sophisticated savers are not going to allow their funds to sit at low rates, that the passbook rates are going to probably decline, not increase. That is the low balances at least certainly are going to be service charged at the point in time when all the ceilings come off.

The **CHAIRMAN**. Well, that is not a matter within our jurisdiction, but it is a matter of interest because we are suddenly learning about the sensitivity of the banks and the S&L's to their concerns about the small savers in their institutions. We want to make certain that they are being properly protected. And we are looking for other ways to help the people you are concerned about, as I am certain you are. We would like to submit some questions in writing.

As I have listened to the testimony, I don't know what the revenue loss would be if we did some of the things you suggest. But I am not certain when we are going to get into revenue type legislation; probably sometime later this year. So we may be asking you to come back in the event we get into that.

If the Budget Committee says to the Congress that we should do certain things in the revenue side, then, of course, it is this committe's responsibility to do that, as we did last year, when they said you should raise $100 billion over a 3-year period. We did it. And we also at the same time granted some relief because we thought there were areas that should be addressed. So we will go through that process later this year. We may be asking for your assistance on that. But I want to assure the witnesses, and I want to thank Mr. Pryde and the two Mr. Greens and Mr. Gray. And we are trying to figure out if the system is fair. I don't think anybody quarrels with the system being fair. At least I think Mr. Gray had it in his statement that that is certainly the policy of all of your associations. And it is hard to know when it is fair. If it doesn't pinch, I guess it is fair. But if it pinches a little, it may be fair but it may not be desirable, I guess.

Thank you very much. We appreciate it and apologize for keeping you waiting.

Mr. GRAY. Thank you, Mr. Chairman.

The CHAIRMAN. Our final witness is Mr. Jay Angoff, staff attorney, Public Citizens Congress Watch.

STATEMENT OF JAY ANGOFF, STAFF ATTORNEY, PUBLIC CITIZENS CONGRESS WATCH, WASHINGTON, D.C.

Mr. ANGOFF. Thank you. Mr. Chairman, Senator Long. I am Jay Angoff, and a lawyer with Congress Watch. And I appreciate the opportunity to testify here today.

The CHAIRMAN. Thank you, Jay. Your entire statement will be made a part of the record. And if you could summarize it for us it would be appreciated.

Mr. ANGOFF. I would be glad to.

[The prepared statement of Mr. Jay Angoff follows:]

Summary Statement of Jay Angoff, Staff Attorney, Public Citizen's Congress Watch

I. Distribution of tax burden between individuals and corporations. The percentage of federal revenues accounted for by the corporate tax has decreased from 30% in the early 1950's to 15% in the 1970's to 5.9% in 1983 (see Table 1). During the same period, the tax burden on individuals, through both the income tax and social security tax, has substantially increased.

II. Distribution of tax burden among different industries.

A. In 1981, effective tax rates by industry ranged from -14.2% for paper and wood products companies to 47.7% for auto companies, according to the Joint Tax Committee. Large commercial banks paid an average rate of 2.3% (see Table 2).

B. In 1980, effective tax rates by industry also varied substantially, according to Tax Analysts and Advocates. Of 30 industries, commercial banks paid the lowest effective tax rate--a negative 1.9%. Instrument companies had the highest effective tax rate, with 39.7% (see Table 3).

C. In 1980, effective tax rates of individual banks also varied substantially. For example, Manufacturers Hanover paid a negative 26.7%, and Chase Manhattan paid a negative 22.4%. The highest tax rate paid by any of the 20 largest commercial banks was 16.2%, by First National Boston (see Tables 4 and 5).

III. The problem with low--or negative--effective tax rates.

A. Equity. Most people have effective tax rates of between 15% and 30%. Even some corporations have effective tax rates of more than 15%. It is unfair for other corporations to pay little or no federal income tax or to get money back from the government.

B. Neutrality. Taxing different industries and different assets at different effective rates creates distortions; it causes people to make investments for tax reasons rather than economic reasons. Whether Congress determines that corporations should be taxed heavily, lightly, or not at all, all assets should be taxed at the same rate to produce the most efficient allocation of capital. Otherwise, the tax system makes good investments bad and bad investments good.

IV. The solution.

A. Short-term.

1. Eliminate or at least limit the use of the tax preferences used by certain industries to dramatically reduce their tax liability. E.g., in the case of banks, tax-exempt bonds.

2. Establish a corporate minimum tax with teeth. E.g., 25% of corporate profits. The 1982 Treasury proposal provides a good starting point. A 25% rate is eminently reasonable in view of the statutory corporate of 46% and the effective rate paid by middle-class individuals.

B. Long-term. Put into practice President Reagan's suggestion in his first state of the union message:

> "The taxing power of government must be used to provide revenues for legitimate government purposes. It must not be used to regulate the economy or bring about social change."

V. Conclusion. If Congress needs to raise revenue it should leave the third year of the personal tax cut and indexing intact and concentrate on base broadening measures. A good place to start is with the banks.

Table 1

BUDGET RECEIPTS BY SOURCE AND OUTLAYS BY FUNCTION, 1974–84

(In billions of dollars)

Description	Actual										Estimate	
	1974	1975	1976	TQ	1977	1978	1979	1980	1981	1982	1983	1984
RECEIPTS BY SOURCE												
Individual income taxes	119.0	122.4	131.6	38.8	157.6	181.0	217.8	244.1	285.9	297.7	285.2	295.6
Corporation income taxes	38.6	40.6	41.4	8.5	54.9	60.0	65.7	64.6	61.1	49.2	35.3	51.8
Social insurance taxes and contributions:												
Employment taxes and contributions	65.9	75.2	79.9	21.8	92.2	103.9	120.1	138.7	163.0	180.7	186.4	213.3
Unemployment insurance	6.8	6.8	8.1	2.7	11.3	13.8	15.4	15.3	15.8	16.6	19.5	24.1
Other retirement contributions	2.5	2.6	2.8	0.7	3.0	3.2	3.5	3.7	4.0	4.2	4.4	5.5
Total social insurance taxes and contributions	75.1	84.5	90.8	25.2	106.5	121.0	138.9	157.8	182.7	201.5	210.3	242.9
Excise taxes:												
Alcohol	5.2	5.2	5.3	1.3	5.3	5.5	5.5	5.6	5.6	5.4	5.6	5.7
Tobacco	2.4	2.3	2.5	0.6	2.4	2.4	2.5	2.4	2.6	2.5	4.4	5.1
Highway	6.3	6.2	5.4	1.7	6.7	6.9	7.2	6.6	6.3	6.7	8.5	11.4
Airport and airway	0.8	1.0	0.9	0.3	1.2	1.3	1.5	1.9	*	0.1	2.3	2.6
Windfall profit tax								6.2	23.2	18.9	14.3	12.5
Other	2.1	1.8	2.8	0.6	2.0	2.2	2.0	1.5	3.1	2.6	2.2	3.2
Total excise taxes	16.8	16.6	17.0	4.5	17.5	18.4	18.7	24.3	40.8	36.3	37.2	40.4
Estate and gift taxes	5.0	4.6	5.2	1.5	7.3	5.3	5.4	6.4	6.8	8.0	6.1	5.5
Customs duties	3.3	3.7	4.1	1.2	5.2	6.6	7.4	7.2	8.1	8.9	8.8	9.1
Miscellaneous receipts	5.4	6.7	8.0	1.6	6.5	7.4	9.3	12.7	13.8	16.2	14.5	14.0
Total budget receipts	**263.2**	**279.1**	**298.1**	**81.2**	**356.6**	**399.6**	**463.3**	**517.1**	**599.3**	**617.8**	**597.5**	**659.7**

Source: U.S. Budget In Brief, FY 1984, Office of Management and Budget.

Table 2

between U.S. and foreign sources is based on information voluntarily disclosed in the companies' financial statements. Effective for fiscal years beginning after December 15, 1976, Financial Accounting Standards Board Statement No. 14 requires certain disclosures relating to foreign operations. The SEC also requires similar information to be disclosed.

Uniform methods of allocating income between U.S. and foreign sources have not been developed; and corporate administrative, capital and product development costs are subject to arbitrary allocation methods. However, the information provided, subject to the accuracy of the allocations, provides information useful in analyzing the effective income tax burden of multinational corporations.

Most companies allocate unrealized foreign currency exchange gains and losses recognized under FASB Statement No. 8 to foreign source income. Net exchange gains decrease the current effective tax rate and net exchange losses increase the effective tax rate. Some companies report high effective foreign tax rates (perhaps in excess of 100 percent) because of the recognition of such losses for financial reporting purposes.

Under FASB Statement No. 52, some foreign currency translation adjustments are not included in net income. Although FASB Statement No. 52 is effective for fiscal years beginning on or after December 15, 1982, some companies adopted this treatment of foreign currency gains and losses in 1981. In this study no attempt has been made to estimate the effect on tax rates of this change in the accounting rules.

Allocation of income taxes between U.S. and foreign sources: The allocation of current income taxes between U.S. and foreign expense is required by the SEC. In some instances, where the amount involved is not material, State or foreign income taxes may be included with U.S. income taxes. Thus, companies that do not separately state U.S. and foreign earnings must at least separately state U.S. and foreign income taxes allocated between current and deferred, when they are material.

Potential overstatement of U.S. tax on U.S. income: The estimated rate of U.S. tax on U.S. income may be overstated to the extent that some portion of the U.S. tax is actually attributable to foreign earnings. This will occur when the foreign tax paid on foreign earnings is less than the U.S. tax on those earnings, so that even after utilization of the foreign tax as a credit against U.S. tax, an incremental U.S. tax is payable on the foreign earnings. It is not possible to adjust accurately for this occurrence on the basis of publicly available information.

APPENDIX B

Aerospace (SIC Code No. 41): United Technologies, McDonnell Douglas, Rockwell International, Lockheed, General Dynamics, Boeing.

Beverages (SIC Code No. 49): PepsiCo, Coca-Cola, Anheuser-Busch, Consolidated Foods, Heublein.

Chemicals (SIC Code No. 28): E. I. du Pont de Nemours, Dow Chemical, Union Carbide, Monsanto, W. R. Grace, Allied.

Commercial Banks: BankAmerica Corp., Citicorp, Chase Manhattan Corp., Manufacturers Hanover Corp., J. P. Morgan & Co., Continental Illinois Corp., Chemical New York Corp., First Interstate Bancorp., Bankers Trust New York Corp., First Chicago Corp., Security Pacific Corp., Wells Fargo & Co., Crocker National Corp., Marine Midland Banks, Mellon National Corp., Irving Bank Corp., Interfirst Corp., First National Boston Corp., Northwest Bancorp, First Bank System.

Crude Oil Production (SIC Code No. 10): Occidental Petroleum, MAPCO, Superior Oil, Natomas, Louisiana Land & Exploration.

Deversified Financials: Federal National Mortgage Assn., Aetna Life & Casualty, American Express, Travelers, Merrill Lynch & Co., H. F. Ahmanson, INA Great Western Financial, First Boston, Loews.

Diversified Services: Phibro, Halliburton, Fluor, Super Valu Stores, Foremost-McKesson, CBS, Fleming Companies, Tesoro Petroleum, AGRI Industries, American Hospital Supply.

Electronics, Appliances (SIC Code No. 36): General Electric, International Telephone & Telegraph, Western Electric, Westinghouse Electric, RCA, Raytheon, Litton Industries, Texas Instruments.

Food Processors (SIC Code No. 20): Dart & Kraft, Beatrice Foods, General Foods, Nabisco Brands, United Brands, Ralston Purina, General Mills, Greyhound, Borden, CPC International, IC Industries.

Industrial & Farm Equipment (SIC Code No. 45): Caterpillar Tractor, Dresser Industries, Deere, Combustion Engineering, FMC.

Metal Maufacturing (SIC Code No. 33): United States Steel, LTV, Bethlehem Steel, Armco, Aluminum Co. of America, Republic Steel, National Steel.

Motor Vehicles (SIC Code No. 40): General Motors, Ford Motor, Chrysler, International Harvester, Signal Companies, TRW, Bendix.

Office Equipment (SIC Code No. 44): International Business Machines, Sperry, Honeywell, NCR, Burroughs.

Oil and Refining (SIC Code No. 29): Exxon, Mobil, Texaco, Standard Oil of California, Standard Oil (Indiana), Gulf Oil, Atlantic Richfield, Shell Oil, Phillips Petroleum, Tenneco, Sun, Standard Oil (Ohio), Getty Oil, Union Oil of California, Amerada Hess, Ashland Oil, Marathon Oil, Cities Service, Union Pacific, Charter, Coastal, Farmland Industries, Agway.

Paper and Wood Products (SIC Code No. 26): Georgia-Pacific, International Paper, Weyerhaeuser, Champion International, Crown Zellerbach.

Pharmaceuticals (SIC Code No. 42): Johnson & Johnson, American Home Products, Bristol-Myers, Warner-Lambert Pfizer.

Retailing: Sears Roebuck, Safeway Stores, K mart, J. C. Penney, Kroger, F. W. Woolworth, Lucky Stores, American Stores, Federated Department Stores, Great Atlantic & Pacific Tea.

Tobacco (SIC Code No. 21): R. J. Reynolds Industries, Philip Morris, American Brands, BATUS, Universal Leaf Tobacco.

Transportation—Airlines: Trans World, UAL, American Airlines, Pan American World Airways, Eastern Air Lines, Delta Air Lines.

Transportation—Railroads: CSX, Burlington Northern, Santa Fe Industries, Southern Pacific, Missouri Pacific.

Transportation—Trucking: United Parcel Service, Consolidated Freightways, Roadway Express, Leaseway Transportation, Yellow Freight System.

Utilities: American Telephone & Telegraph, General Telephone and Electronics, Southern Company, Pacific Gas & Electric, American Electric Power, Commonwealth Edison, Southern California Edison, Middle South Utilities, Consolidated Edison, Texas Utilities.

TABLE I.—FEDERAL INCOME TAX RATES BY SECTOR, 1981

	Thousands of dollars						Percent of tax rate on—		
	Income before tax			Current tax expense			U.S. income	Foreign income [1]	Worldwide [2] income
	United States	Foreign [1]	Worldwide [2]	United States	Foreign [1]	Worldwide			
Aerospace	2,282,317	473,543	2,755,860	156,297	172,943	329,240	6.8	36.5	12.3
Beverages	1,185,983	885,719	2,071,702	342,251	346,457	688,708	28.9	39.1	33.2
Chemicals	3,116,500	2,707,400	5,823,900	154,300	1,545,800	1,700,100	5.0	57.1	29.2
Commercial Banks	2,080,168	3,274,376	5,312,823	47,878	1,247,677	1,311,855	2.3	38.1	24.7
Crude Oil Production	996,075	2,470,[illegible]	3,467,001	31,043	1,030,019	2,048,500	3.1	34.2	52.3
Diversified Financials	1,653,911	238,357	2,292,168	279,816	83,645	395,163	16.8	38.3	17.5
Diversified Services	1,714,074	951,306	2,572,970	507,178	319,152	663,956	29.6	35.5	27.5
Electronics, Appliances	4,563,281	1,723,692	6,272,036	1,795,760	722,004	2,131,066	39.3	42.6	34.3
Food Processors	2,839,725	905,571	3,715,796	752,683	458,973	1,231,575	26.8	50.7	22.6
Industrial & Farm Equipment	1,564,798	556,395	2,033,163	383,574	177,187	560,761	24.1	46.4	27.6
Metal Manufacturing	2,557,389	379,755	3,797,944	248,680	115,629	382,000	9.8	35.1	11.6
Motor Vehicles	1,188,606	448,000	1,899,582	566,704	456,299	240,183	47.7	87.5	21.4
Office Equipment	4,027,124	2,877,055	7,204,379	1,083,807	1,725,576	2,818,527	25.2	60.0	21.1
Oil and Refining	21,488,584	19,737,334	47,536,253	4,003,597	11,912,965	16,082,167	18.6	60.4	33.8
Paper and Wood Products	1,354,145	197,958	1,552,102	(192,877)	57,338	(135,538)	(14.2)	29.0	(8.7)
Pharmaceuticals	1,697,049	1,2[illegible],596	2,97[illegible],645	606,782	615,515	1,176,697	35.9	68.6	20.6
Retailing	2,365,577	305,760	2,671,145	536,766	124,027	642,000	22.7	41.1	20.3
Tobacco	2,563,421	536,340	3,129,761	811,081	113,678	922,550	31.6	21.2	29.5
Transportation:									
Airlines	239,571	95,686	325,374	98,533	25,000	87,489	[illegible]	27.0	17.6
Railroads	1,723,273	—	1,723,273	(129,436)	—	(129,436)	(7.5)	—	(7.5)
Trucking	796,654	16,856	795,395	367,956	5,183	372,733	46.1	47.9	46.9
Utilities	15,375,[illegible]	230,521	16,202,651	1,417,224	81,024	1,514,087	9.2	40.4	8.3

[1] Foreign income as disclosed in the financial statements may be divided between foreign and domestic income in a manner consistent with U.S. tax rules. Current foreign tax expenses may include amounts which are not creditable foreign [illegible] or [illegible] of the foreign tax credit under the applicable U.S. tax rules. For this and other reasons (such as foreign currency translation gains and losses) the foreign tax rate may not be comparable with the U.S. tax rate.

[2] Worldwide income is not necessarily the total of U.S. income and foreign income because some companies do not disclose foreign earnings and because losses are excluded from group totals. Thus, the worldwide tax rate does not necessarily fall between the U.S. and foreign tax rates.

Table 3

EFFECTIVE CORPORATE TAX RATES BY INDUSTRY — 1980

(Percentage of Net Income Paid in Tax)

	U.S. Rate on U.S. Income	Foreign Rate on Foreign Income	Worldwide Rate on Worldwide Income
1. Commercial Banks	(1.9)% †	41.0%	11.2%
2. Container Companies	(1.8)†	44.7	22.8
3. Tire & Rubber Companies	6.1	42.3	39.0
4. Special Machinery Companies	6.4	101.2	19.7
5. Utilities	8.5	—	8.5
6. Airlines	8.9	—	16.1
7. Forest and Paper Products	11.1	37.8	17.0
8. Railroads	12.4	—	12.4
9. Metal and Mining Companies	14.4	26.5	22.4
10. Steel Companies	14.7	44.6	21.0
11. Building Materials Companies	18.2	40.2	19.7
12. Chemical Companies	18.3	47.5	29.8
13. Conglomerates	22.2	33.1	22.7
14. Auto Equipment Companies	22.6	45.5	30.0
15. Office Equipment Companies	23.0	49.2	36.5
16. Oil Companies	25.1	59.9	46.7
17. Non-Food Retailers	27.2	44.4	28.7
18. Aerospace Companies	27.4	42.9	27.1
19. Beverage Companies	29.6	33.9	27.9
20. Drug Companies	31.0	40.7	34.9
21. Food Retailers	31.5	—	31.4
22. Oil Service and Supply Companies	32.3	41.3	33.6
23. Miscellaneous Manufacturers	33.0	43.9	35.7
24. Tobacco Companies	34.2	21.7	31.8
25. Personal Care Products Companies	35.5	38.4	36.9
26. Food Processors	36.3	42.5	37.1
27. General Machinery Companies	37.7	36.2	37.2
28. Publishing Companies	38.2	30.1	34.6
29. Appliance Companies	39.4	(9.7)†	38.0
30. Instrument Companies	39.7	35.9	38.3

†indicates negative tax rates

Table 4

1980 Corporate Federal Tax Burden

LARGEST COMMERCIAL BANKS

Weighted industry averages (10 companies)—worldwide rate: 12.2%; foreign rate on foreign income: 40.1%; U.S. rate on U.S. income: (2.0%).[11]

	Bank America	Bankers Trust	Chase Manhattan	Chemical Bank	Citicorp	Continental Illinois	First Chicago	Manufac-turers Hanover	J. P. Morgan	Western Bancor-poration
Pre-Tax Earnings (in 000's)[1]	$1,021,495	318,753	517,478	322,199	830,000	322,942	48,006	378,031	531,501	290,890
State and Local Income Taxes[2]	(81,000)	(18,219)	(62,217)	(63,422)	(47,000)	(13,617)	200[13]	(54,092)	(72,526)	(25,700)
Worldwide Base Figure[3]	**940,495**	**300,534**	**455,261**	**258,777**	**783,000**	**309,325**	**48,206**	**323,939**	**458,975**	**265,190**
Statutory Rate	46.0%	46.0	46.0	46.0	46.0	46.0	46.0	46.0	46.0	46.0
Permanent Items:[4]										
Investment credit[5]	(5.4)			(14.2)	(2.9)	(5.2)		(14.6)		(3.5)
Tax-exempt income	(5.4)	(12.8)	(15.6)		(4.9)	(17.0)	(62.2)		(18.6)	(29.0)
Capital gains		(4.3)					(5.6)			
Unrepatriated foreign earnings					1.1		(5.0)			
Miscellaneous[6]	(3.9)		(8.2)	1.2	(3.0)	3.2	6.3	(1.9)	(1.8)	1.6
DISC[7]										
Quasi-Permanent Items:[8]										
Accelerated depreciation primarily from leasing activities	(10.6)	(11.2)	(7.3)	(6.6)	(5.5)	(4.6)	(10.5)	(13.4)	(7.2)	(3.2)
Worldwide Rate on Worldwide Income	**20.7**	**17.7**	**14.9**	**26.4**	**30.8**	**22.4**	**(31.0)**	**16.1**	**18.4**	**11.9**
Foreign Base Figure[9]	**543,000**	**187,144**	**248,594**	**99,481**	**788,500**	**101,826**	[14]	**187,125**	**228,687**	**51,000**
Foreign Rate on Foreign Income	**33.5**	**31.2**	**45.8**	**63.0**	**41.2**	**59.8**		**47.3**	**34.5**	**12.9**
U.S. Base Figure[10]	**397,495**	**113,390**	**206,667**	**159,296**	[12]	**207,499**	[14]	**136,814**	**230,288**	**214,190**
U.S. Rate on U.S. Income	**3.8**	**(4.4)**	**(22.4)**	**3.6**	[12]	**3.3**		**(26.7)**	**2.3**	**11.7**

[1] Excludes the results of discontinued operations, equity income from unconsolidated subsidiaries, and income taxes. Equity income is excluded because it is not part of the reported entity's taxable income. Discontinued operations are excluded to promote comparability with other companies.

[2] Earnings before income taxes, as shown on a firm's income statement are reduced by the provision for state income taxes because state income taxes are merely another deduction for purposes of federal taxation. The base figure which results from this subtraction is a more accurate standard for comparison with the federal statutory rate.

[3] The worldwide base figure is used as the denominator in calculating the percentages reported below.

[4] Permanent differences are items such as credits, deductions or exclusions from taxable income which are not intended to be recaptured under the provisions of the Internal Revenue Code. The classification of permanent differences shown in the table is based on the corporation's classification of these items in its Form 10K reports filed with the Securities and Exchange Commission.

[5] The percentages shown reflect the credit earned on assets placed in service during the tax year. For those companies which choose to account for the credit on the deferred method rather than the flow-through method, the percentages shown will not correspond to a company's reconciliation of actual tax burden to the statutory rate for financial accounting purposes.

[6] Items constituting less than 2.3% of net earnings before federal income taxes are not required by the Securities and Exchange Commission to be separately reported. These items are often shown as miscellaneous on SEC reports.

[7] Inclusion of DISC profits in taxable income may be deferred indefinitely if certain conditions are met. Some companies account for such deferral as a permanent difference, others show it as a quasi-permanent difference. Tax Notes reports the effect of DISC in a separate category to avoid having to choose between these two approaches.

[8] The quasi-permanent items are those items of deferred taxes which, in the judgment of Tax Notes' accounting consultant, will probably not be recaptured through taxation in future years. Such items, therefore, reduce the current tax bill and will not increase future tax bills. Hence, the tax reductions to which they give rise are, in effect, permanent.

[9] The foreign base figure represents foreign pre-tax income determined under U.S. tax laws.

[10] Assumes that all equity income and quasi-permanent items are attributable to U.S. operations unless otherwise disclosed by the company.

[11] For 1979 figures, see *Tax Notes*, July 7, 1980, p. 38.

[12] Operations incurred a loss

[13] Reflects refund

[14] Not disclosed

Table 5

1980 Corporate Federal Tax Burden

LARGE COMMERCIAL BANKS

Weighted Industry averages (10 companies)—worldwide rate: 8.0%; foreign rate on foreign income: 49.7%; U.S. rate on U.S. income: (1.6%).[11]

	Crocker National	First Bank System	First Nat'l. Boston	Irving Bank	Marine Midland	Mellon National	National Detroit	Northwest Bancorp.	Security Pacific	Wells-Fargo
Pre-Tax Earnings (in 000's)[1]	$148,376	135,326	163,729	122,749	81,923	140,186	58,840	133,458	289,083	173,253
State and Local Income Taxes[2]	(15,485)	(14,879)	(17,389)	(16,907)	(9,197)	(1,052)	[12]	(10,375)	(24,264)	(14,720)
Worldwide Base Figure[3]	**132,891**	**120,447**	**146,340**	**105,842**	**72,726**	**139,134**	**58,840**	**123,083**	**264,819**	**158,533**
Statutory Rate	46.0%	46.0	46.0	46.0	46.0	46.0	46.0	46.0	46.0	46.0
Permanent Items:[4] Investment credit[5]	(5.0)	(1.2)	(0.1)	(2.4)	(2.8)	(2.3)	(2.0)	(5.3)	(9.3)	
Tax exempt income	(11.8)	(38.1)	(13.0)	(22.2)	(20.7)	(23.6)	(62.6)	(31.7)	(7.1)	(13.0)
Miscellaneous[6]	(1.2)		(2.7)	(2.0)	0.6	(0.9)	(5.6)	1.6	(1.4)	(9.9)
DISC[7]										
Quasi Permanent Items:[8] Accelerated depreciation primarily from leasing activities	(16.1)	(9.1)	(2.4)	(9.9)	(1.3)	(5.6)		(8.3)	(30.0)	(7.5)
Capitalized interest								(1.1)		
Worldwide Rate on Worldwide Income	**11.9**	**(2.4)**	**27.8**	**9.5**	**21.8**	**13.6**	**(24.2)**	**1.2**	**(1.8)**	**15.6**
Foreign Base Figure[9]	**21,898**	[12]	**42,748**	**55,572**	**26,551**	**13,267**	**23,353**	[12]	**13,334**	**63,000**
Foreign Rate on Foreign Income	**88.7**		**60.0**	**40.1**	**67.4**	**99.2**	**29.2**		**124.3**	**18.0**
U.S. Base Figure[10]	**110,993**	[12]	**103,592**	**50,270**	**46,175**	**125,867**	**35,487**	**123,083**	**251,485**	**95,533**
U.S. Rate on U.S. Income	**4.1**		**16.2**	**(24.4)**	**(4.3)**	**4.5**	**(58.9)**	**0.8**	**(8.5)**	**14.1**

[1] Excludes the results of discontinued operations, equity income from unconsolidated subsidiaries, and income taxes. Equity income is excluded because it is not part of the reported entity's taxable income. Discontinued operations are excluded to promote comparability with other companies.

[2] Earnings before income taxes, as shown on a firm's income statement are reduced by the provision for state income taxes because state income taxes are merely another deduction for purposes of federal taxation. The base figure which results from this subtraction is a more accurate standard for comparison with the federal statutory rate.

[3] The worldwide base figure is used as the denominator in calculating the percentages reported below.

[4] Permanent differences are items such as credits, deductions or exclusions from taxable income which are not intended to be recaptured under the provisions of the Internal Revenue Code. The classification of permanent differences shown in the table is based on the corporation's classification of these items in its Form 10K reports filed with the Securities and Exchange Commission.

[5] The percentages shown reflect the credit earned on assets placed in service during the tax year. For those companies which choose to account for the credit on the deferred method rather than the flow-through method, the percentages shown will not correspond to a company's reconciliation of actual tax burden to the statutory rate for financial accounting purposes.

[6] Items constituting less than 2.3% of net earnings before federal income taxes are not required by the Securities and Exchange Commission to be separately reported. These items are often shown as miscellaneous on SEC reports.

[7] Inclusion of DISC profits in taxable income may be deferred indefinitely if certain conditions are met. Some companies account for such deferral as a permanent difference, others show it as a quasi-permanent difference. *Tax Notes* reports the effect of DISC in a separate category to avoid having to choose between these two approaches.

[8] The quasi-permanent items are those items of deferred taxes which, in the judgment of *Tax Notes'* accounting consultant, will probably not be recaptured through taxation in future years. Such items, therefore, reduce the current tax bill and will not increase future tax bills. Hence, the tax reductions to which they give rise are, in effect, permanent.

[9] The foreign base figure represents foreign pre-tax income determined under U.S. tax laws.

[10] Assumes that all equity income and quasi-permanent items are attributable to U.S. operations unless otherwise disclosed by the company.

[11] For 1979 figures, see *Tax Notes*, July 7, 1980, p. 30.

[12] Not disclosed.

Mr. **Angoff**. I would first like to say that we strongly support withholding and we oppose repeal, and we think even by the not very high standards of special interest lobby in Washington, the bankers' campaign to repeal withholding is probably so full of distortions and gross misrepresentations that it is probably a new low. On the other hand, that has nothing to do with why we are here. The reason we are here is simply because banks do not pay their fair share of taxes today, and they haven't paid their fair share of taxes for some years.

Now, the Joint Tax Committee study that just came out shows that banks paid an effective rate of 2.7 percent in 1981. There was another study done by Joint Tax a few months ago at the request of two Ways and Means members which showed about the same thing. That showed that banks paid an effective rate of about 2.3 percent. Of about 30 industries, they were the third lowest.

Now, was this an aberrational year? Well, no. Actually banks paid slightly more in 1981 than they did in 1980. In 1980, for example, according to a study by the respected tax research group in Washington, Tax Advocates and Analyst, banks paid, if you will take a look at table 3 in my testimony, an effective rate of negative 1.9 percent. Of the 30 industry groups they paid the lowest. Now, this negative 1.9 was the average. There were some banks that paid a relatively high amount of 16 or 14 percent. On the other hand, there were some banks, like Manufacturers Hanover, that paid a negative 26 percent; Chase Manhattan paid a negative 22 percent.

Now, what is wrong with this? What is wrong with banks paying low effective tax rates? Well, there are two things wrong with it. One is the equity point; the second is the neutrality point. First, considering equity. It just is not fair for banks or any industry group to pay low or negative rates when there are many people, most people, paying 15, 20, 25 percent of their income, and even some corporations who pay 15 percent of their income and more. It just is not fair to have some people paying nothing or less than nothing, some people paying a lot.

But I realize people have different ideas of what equity is. But I think we can all agree that we need neutrality in the Tax Code; that is, it is up to Congress, of course, to determine what the effective tax rate should be: how a corporation should be taxed. Whether it should be taxed highly, lightly, moderately, or not at all. But whatever determination Congress makes, in order for the economy to work efficiently, that tax should be the same across the board. Otherwise, you get distortions. You get misallocations of capital.

So when one industry group is paying low or negative rates and other industries—for example, in 1981, one industry actually paid just about the statutory rate, 46 percent. Actually they paid about 47 percent, whereas, banks paid 2 percent. This not only is unfair but it creates gross distortions in the economy.

Now, what is the solution to the problem? One solution, of course, is to try to close the specific tax preferences that banks have used over the years. One of those is tax-exempt bonds. If Congress decides that it wants to subsidize State and local governments, which certainly makes sense, certainly that is Congress decision to make, but they should do it efficiently. They should do it by giving a direct grant, by spending money, giving all that money to State and localities rather than doing it through the Tax Code because when you do it through the Tax Code, unintended beneficiaries—that is, largely the banks—get about half the benefit. The States and localities only get about half the benefit. They were supposed to get all the benefit.

Unfortunately, though, we have learned that closing loopholes one at a time just doesn't work. There is too much political pressure. There is organized pressure to keep a loophole open. There is very little pressure, certainly very little organized pressure, to close a loophole. And it is also somewhat unfair to the banks because, after all, the banks are not the only corporations that take advantage of loopholes to grossly reduce their tax. So, therefore, I would suggest that what Congress should do is to institute a strong alternative minimum corporate tax, that is, a tax that would apply to all income—a fair rate seems to be about 25 percent in view of the fact of the effective rate that most people pay, and also in view of the fact that the statutory rate is 46 percent. Twenty-five percent certainly does not seem unfair.

Now that would be a minimum tax on all corporate income, not a cutback in preferences. I realize that there are quite a few serious problems in defining income, but the Finance Committee and the Ways and Means Committee, the Joint Tax Committee and Treasury have some of the finest tax lawyers in the country as members of their staffs. And I am certain that the members of the staff of those committees can work that definition of income out. So we strongly support as a solution to the problem the institution of a 25-percent alternate minimum corporate tax.

Thank you very much.

The **Chairman**. Well, Jay, thank you very much. And we appreciate your testimony and your support. And as I have indicated earlier, this is the first in a number of hearings. We don't know what we are going to find. We don't have any preordained judgments, but I think we have certainly an obligation to take a look, particularly with those great big deficits out there. And everybody suggests that we ought to reduce them if it doesn't affect them. So I appreciate your testimony.

Senator Long, do you have any questions?

Senator **Long**. No questions, Mr. Chairman.

Mr. **Chairman**. Thank you very much.

Mr. **Angoff**. Thank you.

The **Chairman**. This concludes the hearing today.

[Whereupon, at 4:13 p.m., the hearing was adjourned.]

[By direction of the chairman the following communications were made a part of the hearing record:]

Deloitte Haskins & Sells,
Miami, Fla., March 16, 1983.

Re: March 11, 1983 Public Hearing; Taxation of Banks, Savings and Loans, and Credit Unions.

Hon. Robert Dole,
Chairman, Committee on Finance,
Washington, D.C.

Dear Mr. Chairman: We were pleased to attend the above-captioned public hearing in an advisory capacity to the United States League of Savings Institutions, Washington, D.C. and wish to go on record supporting the testimony of its witness, Mr. Roy G. Green of Jacksonville, Florida. In addition, we wish to file this Statement concerning one matter discussed at the hearing.

At the hearing, there was some dialogue concerning the 10 year net operating loss ("NOL") carryback period available to financial institutions as enacted by the Tax Reform Act of 1969. According to our recollection, this was described by one of the witnesses as: a new loophole, only enacted because of the skill of "bank lobbyists."

We respectfully wish to take issue with the above informal characterizations. Further, and directly related, we believe that equity and the economic environment that has confronted the savings and loan industry warrant a significant extension of the NOL carryover period comparable to non-financial institutions. Our reasons are set forth below.

Background.—Under the Economic Recovery Tax Act of 1981 ("the 1981 Tax Act") signed by President Reagan on August 13, 1981, most taxpayers qualify for a 15 year carryover period for NOLs, investment credits, and certain other miscellaneous tax credits. The Internal Revenue Code amendments were retroactive to NOLs and tax credits incurred in taxable years ending after December 31, 1975. The Code amendments evidenced a Congressional intent to lengthen the General 7 year NOL carryover period to 15 years in the spirit of the economic recovery provisions of the Act.

However, financial institutions (S&Ls, commercial banks, SBICs) were excluded from the extended 15 year carryover period for NOLs, although they qualify for the extended period for the other tax credits. These financial institutions remain limited to a 5 year NOL carryover period. The apparent reason for this disparity was the fact that financial institutions are entitled to a 10 year NOL carryback period for NOLs incurred for any taxable year beginning after December 31, 1975. (See § 172(b)(1)(F), IRC.) This extended carryback period was enacted by the Tax Reform Act of 1969 as counterpart legislation to significant permanent reductions in the bad debt deduction available to S&Ls and commercial banks. (The S&L bad debt deduction was reduced from 60 percent of taxable income to 40 percent.)[1]

The House Ways and Means Committee Report Accompanying the Tax Reform Act of 1969 states (see pages 128–129):

"Having reduced the tax-free amount that these mutual institutions will be allowed to add to their bad debt reserves, your committee's bill permits these institutions (and commercial banks), a more generous net operating loss carryback to minimize any possibility of hardship from an unexpected surge of bad debt losses. Under present law, all financial institutions, like other taxpayers, can carry net operating losses back 3 years and forward 5 years. This bill permits financial institutions to carry net operating losses back 10 years and forward 5, in effect, allowing them 15 years to spread their losses."

Note that the 10 year carryback is not unique to financial institutions. For example, in 1978, Congress enacted a special 10 year NOL carryback for companies suffering losses on product liability settlements (see § 127(b)(1)(H), IRC).

A table or synopsis of the above is as follows:

	Pre-1981 Tax Act			1981 Tax Act		
	Carryback	Carryover	Total	Carryback	Carryover	Total
Saving and Loans, banks, etc.	10	5	15	10	5	15
Nonfinancial institutions	3	7	10	3	15	18

Thus, it may be seen that the combined carryback/carryover period for non-financial institutions was extended by 8 years so that it now exceeds the combined/carryover period of S&Ls (and other financial institutions) by 3 years.

Economic environment.—There is no point to reciting, in extreme detail, the earnings and net worth problems of the S&L industry during the last several years. However, some key facts set forth in the public record are as follows:

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[1] The Tax Equity and Fiscal Responsibility Act of 1982 further reduced the percentage of taxable income bad debt deduction by 15 percent of the amount by which the otherwise allowable deduction exceeds the amount which would have been allowable on the basis of actual experience. For some S&Ls, this results in a reduction in the bad debt deduction down to 34 prcent of taxable income. See § 291(a)(3), IRC.

(1) Savings institutions sustained a combined estimated $10 billion loss in 1981 and 1982 due to negative operating spreads (cost of deposits exceeding investment portfolios filled with older mortgage loans) in a period of punishing, high interest rates and economic recession. (See the March 11, 1983 testimony of the United States League of Savings Institutions.)

(2) The S&L industry shrank a record 10.3 percent in 1982 and 7 percent in 1981. This represents a net loss of 442 institutions in 1982 and 326 in 1981. (See the February 25, 1983 edition of "American Bankers," p. 1.)

(3) The FSLIC assisted mergers of 77 S&Ls in 1982, at an estimated aid cost in today's dollars of $1.1 billion. This was an increase from 30 mergers in 1981 at an estimated present value cost of $988 million. (See the February 14, 1983 edition of the "American Banker," p. 3.)

(4) The Director of the FSLIC, H. Brent Beesley, has publicly stated that the number of FSLIC-assisted mergers in 1983 is likely to match the record levels of 1981 and 1982. (See the February 9, 1983 edition of the "American Banker," p. 3.)

(5) According to the FHLBB, the net worth of Federally-insured S&Ls slipped in January 1983 to $25.33 billion from $25.39 billion the month before. The FHLBB also noted that the delinquency rate on mortgages rose in January 1983 to a record 2.25 percent of the total value of mortgages held by insured associations. (See the March 3, 1983 edition of the "The Wall Street Journal," p. 3.) Separately, the Mortgage Bankers Association has reported that, reflecting the continuing effects of the recession, more homeowners were behind in mortgage payments or were in the process of losing their homes in the last quarter of 1982 than in any period in the previous 30 years. (See the February 24, 1983 edition of "The Wall Street Journal," p. 24.)

The above data clearly indicates the economic holocaust that the S&L industry has lived through in the past several years, and the evidence that all the fires are not yet extinguished.

Observations.—The preceding textual material, coupled with our Firm's experiences in the representation of a significant portion of the S&L industry, leasd us the following observations:

(1) The 10 year NOL carryback available to financial institutions is not a "loophole," but was intended to cushion the shock of extraordinary losses. Although more business cycle than credit-related, no one argue that the recent economic experience of the S&L industry was anything short of "extraordinary." Without this provision, the shrinkage of S&L institutions in the last two years would have been materially increased. The only factor that kept many S&Ls from depleting their net worth was the Federal income tax refund available because of the 10 year NOL carryback.

(2) Since the 10 year NOL carryback was intended by Congress to serve the purpose described above, there is no compelling tax policy reason why financial institutions should not have the identical carryover provisions as non-financial institutions. Should Congress take this action, the legislation should be consistent with the 1981 Tax Act. This is, the Internal Revenue Code amendments should be retroactive to NOLs incurred in taxable years ending after December 31, 1975.

(3) The $10 billion of economic losses in 1981 and 1982, when expressed in taxable income (loss) concepts, has caused the majority of the S&L industry to recover all their prior years' Federal income taxes paid.[3] unless the present 5 year NOL carryover period is extended, it is highly likely that NOLs created during these years, and even during 1983, will expire unutilized by many S&Ls. We question the tax equity involved if such events were to occur.

We would be pleased to answer any questions concerning the contents of this letter or supply your office with any additional data requested.

Respectfully submitted,

HENRY D. FORER,
Chairman, National Committee on Savings & Loan Associations.

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[3] This statement might not be true in the case of the approximately 800 S&Ls that were merged out of existence since January 1, 1981. Even if the acquiring S&L incurs substantial losses, it is not possible to carryback these losses to taxable years of the disappearing S&L. See § 381(b)(3), IRC.

FEDERAL HOME LOAN BANK BOARD,
Washington, D.C., March 18, 1983.

Attention: Mr. Ed Danielson.

Hon. ROBERT J. DOLE,
Chairman, Committee on Finance,
Washington, D.C.

DEAR MR. CHAIRMAN: As you know, the Economic Recovery Tax Act of 1981 ("ERTA"), Pub. L. 97-34, amended the Internal Revenue Code of 1954. These provisions addressed the tax-free reorganizations of troubled thrifts, clarified loss carryover rules, excluded from income recapture repayments by thrifts to the FSLIC for capital infusions, and liberalized the rule applicable to a reduction of basis when the FSLIC contributes to the capital of weakened institutions. In a document published in conjunction with hearings held by the Finance Committee on tax treatment for banks and thrifts, the Staff of the Joint Committee on Taxation questioned the continuing need for these provisions in view of recent improvements in industry health and declining interest rates, and suggested that some of these provisions might be limited in duration, or repealed. The Bank Board strongly believes that any such action would be short-sighted and could have severe adverse effects on the public interest both now and in the future.

I am sympathetic to your desire to ensure that the provisions of the Internal Revenue Code reflect sound public policy. However, the limitation or repeal of these tax provisions would have an extremely adverse impact on the ability of the Bank Board, as the operating head of the Federal Savings and Loan Insurance Corporation ("FSLIC"), to resolve the severe difficulties now facing the thrift industry, and to operate at maximum efficiency in the future. Specifically, the current tax treatment afforded thrift supervisory mergers and contributions by FSLIC to assist weakened institutions provides a particularly cost effective means to avoid otherwise unnecessary liquidations of thrifts, to reduce the current pressure of the FSLIC's financial resources, and to protect depositors in FSLIC-insured institutions. At the same time, such exceptional tax treatment has not, to our knowledge, been abused.

Simply stated, current tax treatment of mergers involving failing thrifts and of FSLIC assistance to those thrifts reduces the FSLIC's cost of assisting those transactions. The tax treatment of a supervisory merger or FSLIC assistance through the purchase of assets or capital infusion, and the necessity for the FSLIC to provide indemnification to offset adverse tax effects arising from the transaction, are significant factors which must be calculated into the FSLIC's ultimate cost of assisting the transaction. Moreover, because the cost of FSLIC assistance in a particular case may not, under 12 U.S.C. § 1729(f)(4)(A), exceed the cost of a liquidating payout of insurance, a failing thrift would have to be liquidated in a case where the cost of assistance would exceed that of the payment of insurance on all accounts. While the current tax treatment under ERTA thus averts the need for otherwise avoidable liquidations by fostering supervisory mergers of failing thrifts, the current tax expenditure is also more cost effective than either capital maintenance for thrifts, as provided in Title II of the Garn-St Germain Depository Institutions Act, Pub. L. 97-320 ("Garn-St Germain Act"), or increased FSLIC assistance in supervisory mergers.

In the view of the Bank Board, repeal of the ERTA reforms for thrifts would cripple the FSLIC's ability to resolve the large problems still facing the industry and eliminate significant benefits to the public, resulting from the increased efficiency of the FSLIC and thus increased protection for insured and uninsured depositors. Moreover, we find no justification for elimination of these tax reforms under any scenario regarding the health of the industry.

With regards to the industry's current condition, I must emphasize my firm conviction that the stated premise underlying the Committee's action is a significant distortion of the current state of the industry, and the magnitude of the task confronting the FSLIC. The Committee report thus states that the favorable tax treatment enacted in 1981 "may have been justified by the extremely serious problems which might have been created had it been necessary to enact additional appropriations for FSLIC" if depositors become concerned over the solvency of FSLIC and withdrew deposits from some institutions. The report goes on to note that these provisions may no longer be needed "now that interest rates have fallen and the health of the thrift industry have improved."

It is true that recent rate declines have reduced the negative "spread" between the industry's cost of funds and yield on assets, which accounted for the record losses experienced by the industry in 1981 and 1982. The crisis, however, is by no means over, and thus the FSLIC's need for maximum cost efficiencies continues. While the industry experienced very slight positive earnings in December, 1982, and in January of this year, the cumulative impact of several years of record losses has seriously eroded the capital base of the industry and has left many associations so weakened that they will continue to deteriorate regardless of further positive economic developments. Thus, at the end of November, 1982, regulatory net worth for S&Ls equaled 3.5 percent of assets. This represents a decline from the 4.2 percent net worth level of total association assets at year-end 1981 and is substantially lower than the 5.5 percent level that prevailed before late 1980. Cumulatively, the industry experienced losses of $8.7 billion between year-end 1980 and September, 1982, resulting in the loss of 26.8 percent of the net worth of the industry. As a result, the Bank Board anticipates that FSLIC's caseload, in both numbers and assets of weakened institutions, over the nest year to 18 months will be heavier than it was for either 1981 or 1982.

Thus, the rationale of rational tax treatment of supervisory thrift mergers and FSLIC assistance remains compelling given the current state of the industry. Indeed, because the thrift industry's condition has severely deteriorated since enactment of ERTA, its reforms are more justified and necessary today than they were at the time of enactment. Over the next year, the Bank Board anticipates that it will have to provide assistance for approximately 100 severly weakened institutions which will reach insolvency, and will not be eligible for capital assistance under the Gran-St Germain Act. This is a significant increase over the caseload handled by FSLIC in 1981 and 1982; FSLIC assisted 44 supervisory mergers in 1982 and only 23 in 1981. Moreover, we project that the cost of assistance for fiscal year 1983 will exceed one billion dollars. Significantly, we also anticipate that the cost of resolving these 100 cases will be substantially higher than in the previous two years for several reasons. In prior years, many healthy institutions had a financial incentive to merge with weaker institutions without assistance or with lower asistance as a result of favorable accounting consequences of certain types of mergers. With the recent elimination of these benefits as a result of a change in accounting rules for mergers, this particular incentive no longer exists. Additionally, we anticipate that fewer institutions will be willing to merge to avoid insolvency as the provisions of the Garn-St Germain Act provide capital assistance to sustain institutions as independent entities, if such institutions have net worth-to-asset ratios of 3 percent or less. The result of these and other developemnts is that the FSLIC anticipates that it must now provide greater financial assistance than in the past to induce stronger or healthy institutions to acquire those which have been weakened.

While the continued application of the favorable tax treatment enacted in ERTA is thus critical to the Bank board's ability to resolve current problem cases in an orderly and expeditious manner, we also believe that these reforms should be reatained permanently. The ERTA reforms recognize certain unique considerations in the tax treatment of supervisory thrift mergers and thrift assistance which are of public benefit regardless of the economic health of the industry. Thus, sunset or repeal of these revisions would be extremely short-sighted because it would raise costs to the FSLIC, thus reducing the efficiency of the deposit insurance function for all future supervisory assistance. while this result is particularly pernicious in a time of severe industry crisis, it would be equally undesirable even should the FSLIC experience a sharply reduced caseload.

Further, a large part of the ERTA reforms did not represent "favorable" treatment of thrifts, but were much needed clarifications of the "G" reorganization rules, which were enacted without reference to the problems of the thrift industry, in the Bankruptcy Tax Act of 1980.

The legislative history of ERTA provides abundant evidence that Congress recognized that in the unique circumstances involving the need for supervisory assistance, encouraging assisted supervisory mergers and capital infusions to avoid liquidating payouts was of paramount public interest. Senator Boschwitz's statement on the Senate floor introducing the ERTA amendments affecting thrift assistance clearly illustrates this Congressional intent:

> This amendment would facilitate the infusion of capital to a failing savings and loan or the merger of a savings and loan with another financial institution by clarifying that these transactions are nontaxable events.
>
> The other alternative to capital infusions or mergers in the case of a troubled savings and loan would be liquidation by the Federal Savings and Loan Insurance Corporation.
>
> This would require payment out of their insurance funds to all insured depositors and would have *unfortunate results for non-insured depositors. The potential cost to the Government, depositors and shareholders could be significant.*

> Under current law, there is some uncertainty about the consequences of * * * mergers of savings and loans. *This uncertainty deters potential investors and will likely result in the more costly liquidation pay outs by the FSLIC.*
>
> *(S)urely a merger of a failing savings and loan serves the public interest better than liquidation.*

127 Cong. Rec. S8288 (July 23, 1981) (emphasis supplied).

The benefits of encouraging mergers and avoiding payouts will continue to bolster the efficacy of the deposit insurance system regardless of the economic environment in which the supervisory assistance occurs. Consequently, there is no justification for the limitation or repeal of the ERTA provisions affecting supervisory mergers or assistance.

Finally, we must object in particular to any limitation or repeal of the provisions regarding the net operating loss carryover provisions, as we have encountered no abuse of this authority. The current rules regarding continuity of interest and net operating loss carryovers apply only in cases where the Bank Board certifies that the institution to be reorganized is insolvent, has experienced a substantial dissipation of assets or earnings, or is in an unsafe or unsound condition to transact business.

By their nature, supervisory thrift mergers do not present significant problems with respect to tax-motivated takeovers or trafficking in loss companies, which such a repeal arguably might address. Moreover, the ERTA Conference Committee report clearly states the Conferees' intent that the requisite certification for the tax free reorganization and net operating loss carryovr treatment set forth in ERTA should not be made where the association has intentionally placed itself in a position where one of the grounds for certification would otherwise apply. S. Rep. No. 97-176, 97th Cong., 1st Sess. at 284 (1981). The Bank Board's ploicy in this regard provides further insurance against any abuse of this provision, as certification on grounds of insolvency will be made only after a determination that the institution has less than twelve months to insolvency.

In closing, I am confident that the tax treatment currently afforded thrift supervisory mergers continues to serve the public interest. Please feel free to contact me or any or my staff if we may be of any further assistance to you in this matter.

Sincerely,

RICHARD T. PRATT, *Chairman.*

STATEMENT OF ROBERT C. FINCH

I am grateful to Senator Dole, the members and staff of the Senate Finance Committee, for the opportunity of setting forth my views as Congress sets forth to adopt a vitally needed revision of our comprehensive banking laws.

By way of qualification, I make no pretense at being an economist nor at being sophisticated in the refinements of banking. My views stem from over 20 successful years in the real estate and development business in Santa Barbara during which time I have dealt with a multitude of banks and banking agencies. Likewise, my activities offered me the opportunity to interface with a wide segment of the public, and I am convinced that my suggestions accurately reflect those of depositors, tenants, retirees and others who must deal with financial institutions.

As the Finance Committee well understands, the world of telecommunication and the computer has shattered the rigid statutory and other distinctions that were built into the financial system at a time when the movement of paper, currency and other instruments made a more cumbersome process necessary for accountability. I would estimate that in five years a home computer as manufactured by IBM, Honeywell, Tandy Corporation and a raft of others will sell for $300, and directly link the central bank with the homeowner or renter. It may also be true that within ten years, the home computer could be as a common as a stereo or a television and the capacity to handle reciprocal financial transactions will be a common feature of these devices.

With this in mind, specific proposals to the Senate Finance Committee are as follows:

(1) The present laws on the books be enforced by the Comptroller of Currency. It is my opion that at present the Comptroller of Currency does not have an adequate staff and sufficient resources to properly enforce current laws. Having been associated with the real estate and development business in Santa Barbara for many years, I have personal knowledge that some large banks float trust accounts for up to 61 to 63 days. Obviously, this practice takes vast sums of money out of the economy to the benefit of bank stockholders, but at the expense of widows and orphans, and others

who need the money. For example, if a widow has an estate of $100,000 and the bank does a good job of investing her money, she may earn as much as 12 percent or $12,000 per year. On the other hand, if the banks kite her interest income for a period of 60 days, which amounts to using $2,000 of her money per year, they should make at least 18 to 24 percent on that $2,000. A present law directs banks to reinvest any monies over $1,000 within a day or two for the benefit of the trustee. In some large banks (and I'm sure in smaller banks), a percentage of banks' capital needed to assist the economic recovery of this country is withheld outside the law for the bank's private benefit. Obviously, if trust legislation is enacted, institutions other than banks should be included and the primary purpose of this legislation should be to protect the man or woman who is deceased, who perhaps spent their lives in however a successful effort to build an estate for those they love, only to have that estate dissipated by the trustor for current, private benefit.

(2) That the practice of certain western banks requiring a $100 check or cash to open a checking account be reduced to $10. During the recession of the last four years, many people could not get $100 together to open an account. I recall in New Hampshire four years ago, you only needed $1. Perhaps $100 is computed to be the break even point, but it seems to me that any person with change in his pocket should be able to open a bank account. Who knows—he may be a student and may some day own a bank, or buy the bank he wants to make a $10 opening deposit in.

(3) Bankers should not be allowed to close an account with an overdrawn statement. In essence, bankers should not have it both ways. They should be allowed to bounce checks to preserve an account, but if they themselves allow an account to become overdrawn as a result of their operational procedures, they should not then be entitled to arbitrarily close an account.

(4) That a law be enacted requiring banks to return to some major extent money deposited by depositors in the local community to their community. Basically, branch banks in suburban or farming or ranching communities collect the money from deposits in those areas and the big city lender spends it. This practice deprives the farmer in New England of resource capital because it is spent in Boston to build a highrise building or a new printing press for a newspaper. This deprives the cotton farmer in the South of money to buy seed for his crop, or the barley farmer in Kansas of the same privilege, or a man and woman outside of Albert Lea, Minnesota trying to support a family on 360 acres of soy beans and alfalfa and the banker shakes his head, and the Alber Lea Seed House does not sell the seed, and the banker forecloses on the farmer and takes his land so that he may loan money to IDS to build a tower in Minneapolis that remains vacant for about two or three years. In truth, the banker would better serve his interest and the interest of the country if he would better serve the concept that money should be loaned where money is earned.

(5) That fire, life and casualty companies be allowed to become bankers. Because of the advent of computers, there is no longer the need for large buildings. It is unreasonable to allow stock brokerage companies to become bankers and not allow insurance companies. I would hope that various insurance companies would support this proposal and that associations of the industry will support this idea and that the law could become effective as soon as possible.

In essence, it will make each insurance agent a banker—and then, perhaps, for all time the mystique is taken out of the banking industry because the computer will provide the knowledge on discount rates and the insurance broker will know the client better than the banker.

The reason this is true is the that banks generally do not get to know their customer, but insurance agents and brokers do. As an example, I personally have been prominent in the real estate brokerage business in Santa Barbara for a long time, and for 22 years I have had the same insurance agent.

On the other hand, I have changed banks on several occasions because banks run out of money, or competent lenders, or competent operations officers, or competent managers, and the personnel movement in banks is substantial. On the other hand, an insurance agent or broker will stay in his community all of his life.

If the tremendous capital worth of the insurance industry, and the competence of their personnel, together with their very substantial daily cash flow, were inserted into the banking marketplace, the people of this country would immediately find a more competitive banking system.

Certainly, the insurance industry can cash a check as well as anyone else and make a commercial or real estate loan as well as anyone else. To give you an example of the duplicity of our present system—normally banks made construction loans usually only after an insurance company on large projects provides a "take out loan" which is a form of insurance provided by the insurance industry to the banking industry at no charge. The reason this is true is the duplicity of points paid by the builder or developer—2 or 3 points or up to 6 points depending on the project to the bank, and the same to the insurance company.

It is my proposal that one entity make both the construction loan and the "take out" loan, thereby reducing the construction cost of a project by as much as 3 to 5 percent. Certainly, the insurance industry would get into construction loans if they were allowed to get into other banking functions, and because of additional competition—interest rates would come down—and more people would buy cars and tractors, and avocados and sweet corn this summer, for the simple reason that they will have more spendable income at reduced interest rates. The final argument is that, almost immediately, people would have jobs, and of course then the banks would benefit as well by increased deposits.

(6) I think it reasonable that companies such as Safeway and Sears be allowed to open banks owned by them on their premises.

(7) I think it reasonable that American banks in any locality be allowed to buy banks in another area—based on the premise of free trade—since we do allow a bank in London to buy a bank in California.

If you, or any member of the Committee, have any questions, please write me at Douglas Wilson Real Estate Company, 115 East Victoria, Santa Barbara, California 93101; phone: 805/903-9238.

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